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CIS

IS REAGANOMICS WORKING?

HEARING

BEFORE THE

SUBCOMMITTEE ON MONETARY AND FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

SECOND SESSION

JUNE 9, 1982

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IS REAGANOMICS WORKING?

WEDNESDAY, JUNE 9, 1982

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON MONETARY AND FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:07 a.m., in room 5110, Dirksen Senate Office Building, Hon. Mack Mattingly (member of the Joint Economic Committee) presiding.

Present: Senator Mattingly; and Representatives Reuss and Richmond.

Also present: James K. Galbraith, executive director; Charles H. Bradford, assistant director; Bruce R. Bartlett, deputy director; and Richard Vedder, professional staff member.

Senator MATTINGLY. I call to order the Subcommittee on Monetary and Fiscal Policy.

First, I would like to welcome my colleague and chairman of the Joint Economic Committee, Congressman Henry S. Reuss.

I will make my opening statement first.

OPENING STATEMENT OF SENATOR MATTINGLY, PRESIDING

Senator MATTINGLY. The President's economic program will lead this Nation to recovery. The progress toward this goal has already begun. When President Reagan took office, inflation was running at double-digit levels, the prime interest rate was over 20 percent, and the country was suffering from 8 years of almost no growth in labor productivity.

It took years of economic mismanagement to get the country in this fix, years of overspending, years of overtaxing, years of overregulation, and years of irresponsible monetary policies. This record of economic blundering is unmatched in our history and it can be laid at the doorstep of the Congress. Every appropriation that drained the Treasury passed both Houses. For years Congress sat on its hands while bracket creep rewarded Government for inflation. No one worried past the next election because the printing press could always be speeded up.

Now we find that within a few months of congressional passage of a portion of the President's plan, the big spenders are ready to declare it a failure again. The fact is that most of the program hasn't even taken effect yet. Clearly we must let the program take full effect before we can fully and accurately evaluate it. We would be further along the road to recovery now if Congress had passed the original tax reduction with a full 1981 tax cut.

The signs of recovery are now appearing in our economy. Inflation has been beaten, interest rates are slowly declining, and the trend should continue. The unemployment rate, traditionally a lagging indicator, has flattened out and should begin to decline. Total employment increased by 777,000 in May. The average work week also increased in May. The savings rate is higher than it has been in years, a sign that capital formation will be available and that will help raise our productivity.

Why alter a program that is just beginning to work? That is foolishness. I find it especially ludicrous that some are suggesting a return to the policies that led us into this economic wilderness. They would have us cancel the tax cuts, the critical element of the economic program. How raising taxes will solve this recession, I do not know.

If my friends from the other body want to know what they can do to help this recovery along, though, it is pass a budget. That's all I heard during the recess. Why can't Congress pass a budget? Many believe the Democratic leadership hopes to foul things up long enough to profit in November. I personally cannot believe that anyone would be that cynical. I know we all have the country's best interests at heart. We have had bipartisan cooperation up until now and I hope the same spirit will prevail in the current budget battle.

The basic problem some of my friends across the aisle have is they think of the people as nothing more than consumers. They are producers first and consumers second. With the incentives built into the President's program we can produce our way out of this recession, but only if we allow those incentives to take effect.

I look forward to hearing from our distinguished chairman of the President's Council of Economic Advisers, Hon. Murray L. Weidenbaum, as well as from two other noted economists, Profs. James Ramsey and Gordon Tullock. First, we will have an opening statement from our distinguished chairman of the Joint Economic Committee, Congressman Henry S. Reuss.

Representative REUSS. Thank you, Senator. I have no opening statement other than to congratulate you for holding this hearing and having our friend, Chairman Weidenbaum, before us once again. I look forward to his testimony.

I do want to join with you in your denunciation of those cynics who might suggest that Democrats would play politics with the budget. That was a point well made.

Senator MATTINGLY. Thank you very much. Henry, this is the first time you and I have agreed in a long time—I'm kidding. [Laughter.]

Representative REUSS. I like to be bipartisan. [Laughter.]

Senator MATTINGLY. Yes.

Before proceeding, and without objection, I will place Senator Hawkins opening statement into the hearing record at this point.

[The opening statement of Senator Hawkins follows:]

OPENING STATEMENT OF HON. PAULA HAWKINS

I am pleased to welcome Mr. Weidenbaum and the distinguished panel of economists to this hearing.

The theme of the hearing is "Is Reaganomics Working?" This is a valid question to ask, but I would point out that the President's economic program was enacted less than a year ago and important parts have not yet taken effect, such as personal tax cuts.

Reaganomics will work, but we must be patient. The President's program was not enacted to deal with short run business cycle problems, but rather is a long term program designed to stimulate productivity, stable prices and employment opportunities. It took us decades to get us into our current economic mess, so I think we must be patient and not expect to get out of that mess in a few months. At the same time, however, I think we should be encouraged by the dramatic success we have had so far in dealing with one of our most critical problems, inflation.

I look forward to hearing the views of our distinguished visitors.

Senator MATTINGLY. Mr. Weidenbaum, please proceed.

STATEMENT OF HON. MURRAY L. WEIDENBAUM, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. WEIDENBAUM. Senator, with unemployment at 9½ percent, interest rates painfully high, and recession extending beyond the 6 months that the milder downturns have lasted, this is an interesting time to answer the question, "Is Reaganomics Working?"

Except for that mythical one-armed economist who can always arrive at simple conclusions, it clearly is too early to make a clear-cut evaluation on the basis of current economic data alone. It is obvious, of course, that we have not succeeded in eliminating the business cycle. To be sure, that feat was never promised. But a downturn in the economy is hardly a propitious moment to crow about the success of a new approach to economic policy.

Before I offer a long term evaluation, let us examine the current status of the economy. Yes, we are in a recession. But that was to be expected, and it was anticipated. In a number of testimonies and other public statements beginning in March 1981, I warned about the possibility of one or more quarters of decline in the period ahead—"negative growth," to use the economist's awkward phrase. In fact, the unpublished worksheets supporting our economic "White Paper" of February 18, 1981, estimated two consecutive quarters of negative growth, which corresponds to the common rule of thumb for calling a downturn a recession. In practice, the recession was later and deeper than anticipated, and I will deal with that point in a moment.

But why was a recession to be expected? The answer is quite straightforward—the economy is adjusting to the necessary winding down of the unsustainable rapid monetary stimulus that characterized the second half of 1980 and earlier periods. It is hardly an original observation on my part to note that the seeds of each recession are sown in the excesses of the preceding period. Specifically, the second half of 1980 witnessed the most rapid growth in the money supply since the end of World War II—M1 rose at an annual rate of 13 percent.

The fact that the recession did not start until the latter half of 1981 is a tribute to the underlying strength of the American economy. But I attribute the deepness of the recession to the fact that interest rates remained higher longer than most analysts anticipated. Because monetary policy is the key to these short-term developments, I would like to turn to that area of economic policy.

A LOOK AT MONETARY POLICY

To begin with, I do not blame Federal Reserve policy in 1981–82 for the current recession. The shift to a lower trend of monetary

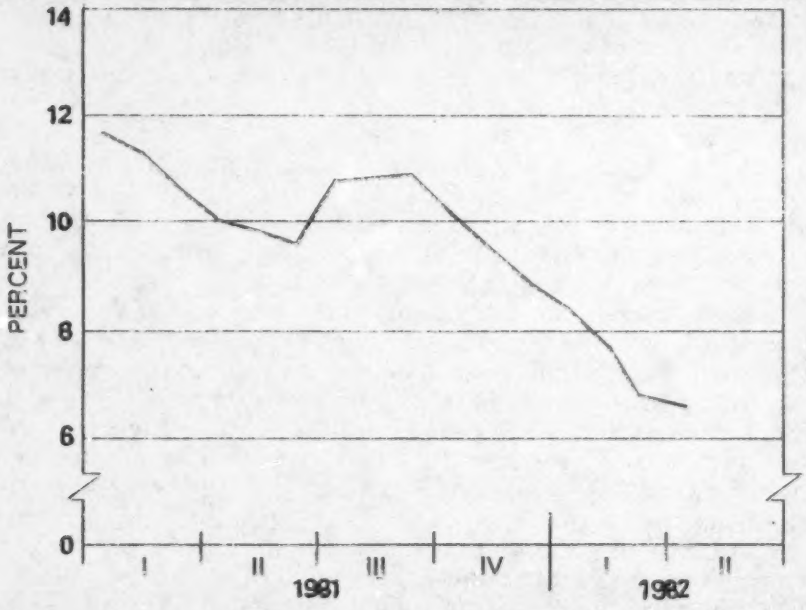
growth was essential to deal with the escalating inflation which characterized the American economy at the beginning of 1981. That was precisely the policy which we urged in the February 18, 1981, "White Paper" and on numerous subsequent occasions. The growth in M1 for 1981 averaged 5 percent for the year, which was a bit below the Fed's target range for the year. Given the varying lags with which monetary policy affects the economy—and the variations in estimates of that lag provided by monetary specialists—I find it hard to draw any special conclusions other than the basic one: policy shifted from ease to restraint.

I do, of course, associate the lessened growth in the money supply with the substantial reduction in inflation during the past year. Figure 1 shows the change in the underlying rate of inflation.

[Figure 1 follows:]

FIGURE 1

CONSUMER PRICE INDEX
PERCENT CHANGE FROM 12 MONTHS EARLIER



Mr. WEIDENBAUM. Some monetary specialists have also associated the very short-term shifts in M1 with similar movements in interest rates. I find this an interesting case of intellectual development, since many of those same experts had earlier urged us to downplay both short-term movements in the money supply as well as the interest rate effects of monetary policy. Personally, I am inclined to take the more eclectic attitude of "live and learn."

In any event, the 1982 annual report of the Council of Economic Advisers contains several suggestions for improving the monetary control mechanism, such as shifting from lagged reserve accounting to contemporaneous reserve accounting. Nevertheless, we have no truly

satisfying account of why interest rates have remained so high. But I do share the view that interest rates are the key to why recession has persisted.

THE ROLE OF FISCAL POLICY

The presence of high interest rates has focused unusual attention on fiscal policy, especially the large budget deficits. To acknowledge the obvious, the deficit for the current fiscal year is much larger than we had originally anticipated, as are the estimates for future years. A variety of factors is involved. The economy is weaker than we had earlier projected. That, in turn, has reduced revenue growth and increased the cost of the "entitlement" programs.

But even good economic news has brought bad budget news: The great progress on inflation means a lower base of nominal income and thus a slower flow of revenues into the Treasury. In addition, the tax cuts enacted, especially for future years, were larger than in our original estimates. Furthermore, spending cuts have not been forthcoming at the rate we earlier had envisioned. I do not offer these observations in an effort to assign blame. I believe, frankly, that there is enough blame to go around in a truly nonpartisan manner, in accordance with your colloquy with Representative Reuss.

The large budget deficits have become a popular way of explaining high interest rates. Frankly, I find that it is hard to say anything in this area without being misinterpreted. There are so many partisans of received doctrine who stand ready to pluck out any individual statement, or even fragment thereof, and either embrace it uncritically or castigate it unmercifully. Nevertheless, I will try to deal with the relationship between interest rates and budget deficits on the basis of present knowledge.

First of all, we must acknowledge the fact that the economics literature does not provide us with clear guidance. Many competent economists have tried without success to find a direct relationship in past periods between budget deficits and interest rate movements. Because they studied periods of recession with accompanying rising deficits, the results are less than fully relevant to analysis of fiscal 1983 and beyond, a period of expected economic growth.

As I understand the matter, financial markets are especially concerned about deficits in 1983 and the years that follow. Then the problem will be quite different from the earlier periods, in that large budget deficits will be competing with rising private investment demand for the same pool of savings.

Surely, large budget deficits do not augment the supply of saving, but increase the demand for investment funds. Thus, I am led to the conclusion that the projections of large deficits have exerted upward pressures on interest rates, although we cannot measure that effect with mathematical precision.

I must note, somewhat sadly, the tendency to behead—or at least badly batter—the messenger who brings the bad tidings. If anything has become clear in the past year, it is that it is foolish to attack those who project large budget deficits for their alleged lack of faith in "supply-side" economics. I for one do not view economics as a branch of theology. Nor do I consider the term "demand" as obscene.

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As the great neoclassical economist Alfred Marshall taught us, there are two blades to the economic scissors—supply and demand.

Indeed, a basic concern of the Reagan economic program is to redress the balance; a balance which, in the past, had been the result of excessive attention to demand. And precisely, our attention to supply is to redress the balance, not to create a new imbalance. That is, we emphasize the restoration of the necessary incentives to work, save, and invest.

But it would be futile to ignore the complicated nature of the interrelationships or the pain of adjustments involved. Quite clearly, the tendency has not been to overestimate the resultant deficits, but to lean too much the other way.

To state the matter baldly, but I believe with fundamental accuracy, there is nothing wrong with Reaganomics that larger budget cuts will not help to cure. It has become more apparent than ever during the past year that it is easier to cut taxes than to cut Government spending. And the notion that cutting taxes is the easiest way to cut spending through resulting pressure on deficits we have seen is merely wishful thinking. To restate the obvious: The only effective way to reduce spending is for Congress to appropriate less. We need to do both: cut taxes and cut spending.

From the outset, the Reagan administration has been dedicated to reducing the burden of Government in all its dimensions—lower taxes, less spending, and less regulation. Surely, we have not been able to move on all three fronts evenly.

Those large budget deficits emphasize the need for more effort on expenditure restraint. To say so surely is not evidence of any lack of faith in Reaganomics. Rather, it reflects an effort to bring the discussion back to reality.

WHERE DO WE NOW STAND?

We are experiencing a serious recession, on a par with the average downturn since the end of World War II. A frequently asked question is: Why is unemployment so high? I offer a two-part answer:

First of all, this administration started from a high level of 7½ percent unemployment.

Second, we have not eliminated the business cycle and unemployment has risen during the current recession—and I want to emphasize this—but less to date than during the 1974–75 recession, less than others.

Specifically, unemployment rose by 3.8 percentage points from the third quarter of 1974 to the second quarter of 1975. As for the current recession, unemployment has risen to 9½ percent from 7½ percent in the first quarter of 1981, a rise of 2 percentage points.

In good measure, because of those high interest rates, we have not seen the growing signs of recovery that I would have expected at this stage of the cycle. However, a few welcome straws in the wind have been noted recently, such as the modest upturn in the leading indicators and the strong showing in car sales.

But more fundamentally, we are seeing the normal cyclical adjustment process at work. Business has been reducing inventories at an extremely rapid rate. Meanwhile, consumer spending in real terms has

increased slightly. The July tax cut will—as we have always anticipated—expand both consumer saving and consumer spending. It will reduce the tax intake.

Thus, an increasing array of business firms should find it necessary to replenish their depleted inventories. The resultant reordering is typically the key to beginning the recovery.

A word about business investment is in order. Despite the more enthusiastic expectations of some, capital spending once again is performing true to form as a lagging indicator. Typically, investment outlays constitute the second stage of recovery, following the expansion of consumer purchases.

Once the economy begins to pick up, I expect that the new tax incentives will help make for strong growth in capital spending. But any rapid expansion will depend in good measure on our success in bringing interest rates down much further. Given adequate capacity in so many industries, it is hard for me to envision a boom in investment in the short run.

On balance, I see prospects for a healthy recovery, one that does not quickly reignite inflationary pressures. The adjustments to the less inflationary environment now taking place should result in an increasingly productive economy, one that is more competitive in world markets.

There is indeed a new sense of realism in economic decisionmaking visible today, with clear emphasis on cost containment. But the change is quite recent. It could readily be reversed, should the Federal Government decide to "bail out" the losers in the marketplace.

Ours indeed is a profit-and-loss system. There are two key implications that need to be taken into account in policymaking, from a profit and loss system:

First of all, profits earned in that marketplace are not "excessive" or "windfall" or "obscene," to use phrases that politicians and journalists have succumbed to so frequently.

But neither are the losses that occur in that marketplace an appropriate reason for Government intervention.

Neither easy credit nor high tariffs nor other similar responses at the expenses of consumers or taxpayers are justified. To tighten up on Government social spending, in my judgment, is appropriate and fair—and it is a necessary part of any comprehensive budget restraint effort. But simultaneously, were we to loosen up on subsidies to various producers' interests, that would be clearly unfair.

As I have tried to explain on many previous occasions, a simple-minded, pro-business attitude is not synonymous nor is it always compatible with this administration's genuine love affair with "the magic of the marketplace."

IS REAGANOMICS REALLY WORKING?

In answering the question, "Is Reaganomics working?", I feel like the physician who gave his patient—in this case, the economy—a carefully prepared batch of prescriptions and a stern set of instructions. But the pharmacist—in this case, the Government—proceeded to fill only a few of the prescriptions, and, even for those, reduced the dosage.

Thus, I believe this administration has prescribed the correct long term medicine for the American economy—tax cuts reducing the Government's share of the national income; budget restraint that slows down the growth of Federal spending; regulatory relief that reduces the many burdens that Government imposes on the economic process; and a sensible monetary policy that gears the money supply to the needs of a growing but less inflationary economy.

Looking back over the past 16 months, I must report that the political process—and that involves both the legislative and executive branches, and both political parties—has been slow to take this medicine in the full dosage prescribed.

I do believe that enough of the medicine—major portions of each of the four points in the Reagan economic recovery program—has been taken so that in the course of the year ahead, we will see substantial progress. This progress will yield renewed growth in a less inflationary and more productive environment.

But the precise rate of progress will depend on the regimen that the patient takes, on our ability to reduce the budget deficits, in reforming popular but needlessly burdensome regulation, in achieving a more stable and moderate growth pattern in the money supply, and surely in avoiding going off the diet via a round of bail-outs or protectionist legislation.

While some may have expected economic miracles to occur overnight, such naive expressions could only have generated false hopes. Durable improvements in the performance of the economy will come slowly. These real benefits will not be the result of pronouncements by economists or politicians. Rather, true economic progress will be the consequence of hard work and saving and investment, year in and year out, by the American people.

Senator MATTINGLY. Thank you, Mr. Weidenbaum.

I have several questions I would like to ask you.

Charles Schultze, your predecessor, said the U.S. economy had actually been in a recession since late 1979. Do you agree with that?

Mr. WEIDENBAUM. If Charlie Schultze wants to claim credit for the current recession, I am not prone to argue with it.

I was relying on the National Bureau of Economic Research, which is the unofficial but universally accepted custodian of business cycle data points. And the National Bureau, in its wisdom, had said the 1980 recession had ended some time ago. Very frankly, I never thought that 1980 was a period that economic growth, in any sustainable way, had been restored.

So that, looking back over this entire period, quite clearly—the period beginning actually before 1980—for some years has been characterized by low productivity, low capital formation, sluggish growth, and rising inflation. This was the early phase of the cycle that I described in my testimony.

Senator MATTINGLY. Wouldn't you agree that efforts to correct the previous recession—in fact, the seven previous recessions—had come too late to do any good, and the programs to correct those recessions actually hit us in the recovery phase?

Mr. WEIDENBAUM. Yes, indeed. The typical quick fix approach. And frankly, this has been done in administrations of both political parties.

Typically, by the time those programs got going, the economy not only was already recovering, but those bail-out approaches exacerbated any inflationary potential and just kicked off another cycle of stop-and-go. They were counter productive.

Senator MATTINGLY. The two areas that I am very interested in—and I am sure you are, and most Americans—should be:

One, the budget and the tax side and the spending side.

Do you know of any—speaking of the tax side—any economist that would advocate raising taxes during a recession?

Mr. WEIDENBAUM. I don't know of any, but I would not pay much attention to him if he did—or her.

Senator MATTINGLY. Then it would lead us to believe that the fiscal year 1982 budget we passed, with the tax incentives that are actually in place, was fortunate to have in place for a recession. Is that correct?

Mr. WEIDENBAUM. Yes, sir. I think the long-term tax program that the Congress enacted last year is an important ingredient in the recovery of this economy, that I anticipate later this year.

Senator MATTINGLY. I have another meeting this afternoon, which will be the conferees of the House-Senate Appropriations Committees on the urban supplemental bill. Prior to the recess a $5 billion mortgage interest subsidy was passed.

You know, we are talking about trying to have austerity and controlling the budget.

What is your opinion of that action?

Mr. WEIDENBAUM. I think that would be a major step backward. I can only think of strong negatives, from every point of view.

First of all, it would send absolutely the wrong signal to financial markets. It would say that those skeptics who have kept interest rates high, because they do not really believe inflation is coming down, may turn out to be right. And I think that is absolutely—just the absolute wrong signal.

It is not just psychology. Those bailouts—and that one specifically—will increase the budget deficit, putting upward pressure on interest rates. If there is anything that the housing industry needs—and this is universally agreed in the housing industry—it is lower interest rates.

So, a bailout proposal that would result in higher interest rates is just dumb.

There is an equity matter involved here. The average forecaster expects approximately 1 million new starts. The optimists have larger numbers for this year. We know the bailout proposal would give a very small fraction of those 1 million people, maybe 70,000 people, a lucky break, an advantage, a reduced interest rate on their mortgage, and the other 930,000 people who will be buying new homes won't be getting the break. The break will be subsidized by all taypayers and, if you look at the income cutoff, an awful lot of taxpayers whose incomes are a lot lower will be subsidizing the lucky few whose incomes could be significantly—and that is my understanding of the bill—above that of the average taxpayer in the United States.

I think it is a most unfortunate and unfair piece of legislation.

Senator MATTINGLY. Part of Reaganomics, if we want to refer to it as Reaganomics or supply-side economics, is trying to spend less and tax less, to which I adhere. This afternoon I will try to do, I hope with

your aid, what I can to help take that subsidy out of the bill, but if it does not, I hope Reaganomics goes to the point of a veto of that.

What is your opinion on that at this time. Would the President veto it, hopefully?

Mr. WEIDENBAUM. The President, of course, has a longstanding policy of not making a decision on a specific bill until it reaches his desk. I think that is a wise matter, although he also points out that he knows how to sign veto messages. He signed quite a few of them when he was Governor of California for 8 years. I oppose that position, and I would continue to urge the President to oppose that position.

Senator MATTINGLY. In yesterday's Wall Street Journal, the president of the National Bureau of Economic Research, Martin Feldstein, said there is not much we can do in terms of government policy, but wait for the interest rates to begin their decline. Do you agree with that?

Mr. WEIDENBAUM. In its fundamentals; yes. As I understand it, Martin Feldstein is urging the continuation of the Reagan economic program and not the backsliding to easy money. In fact, he has got references just to that point. We concur completely with that notion that a return to easy money policies would just exacerbate inflation and turn interest rates around, and we would lose any progress that we have made on interest rates. They have come down significantly. The prime rate was 21 to 21½ percent in January of 1981. It is 16½ percent and some banks have lowered it to 16. We might lose a good deal of that progress, as well as the progress on inflation, as I have testified. Therefore, I strongly agree that we need to maintain the current thrust of policy, but I suggest that maintaining current policy involves a lot of additional specific actions.

We have the tax program in place. We made some very minor revenue suggestions, as you know, but there is an awful lot to do on the expenditure side. Last year's budget cuts were only—although important—the first installment on an ongoing effort. We need to do a lot more. When I say "we," I mean both the executive and legislative branches to carry out this year, next year and the year after, the policy and practice of budget restraint. And also we need to carry out the regulatory relief program, which will, of course, mean a lot of additional administrative, as well as legislative, actions designed to reduce the unnecessary burden of regulation. So this is hardly a "do nothing" policy. It is an active policy, but maintaining the thrust of Reaganomics, in fact, carrying it forward.

Senator MATTINGLY. I will come back to ask you some more questions about whether we are cutting the budget or whether we are just slowing down the growth, but my time is up, and I will turn the questioning over to Congressman Reuss.

VERSAILLES SUMMIT: NO CHANGE IN U.S. POLICY

Representative REUSS. Thank you, Senator.

Chairman Weidenbaum, I would like to ask a number of questions about the Versailles summit. You, as I understand it, were not present at it, but sometimes those who gaze up at the summit can perceive what is going on, as well as or better than those who are at the top and find

their vision obscured by fog, snow, or whatever else you find at the summit——

Mr. WEIDENBAUM. I'm not sure from what direction we're looking at it, up, down, or sideways, but fine, I get the spirit.

Representative REUSS. You were not there?

Mr. WEIDENBAUM. That's right.

Representative REUSS. But I still want to ask my question for the reason given. Prior to the summit, the administration's economic policy was based on an increase in military spending, a 3-year Kemp-Roth tax reduction, and support for the Federal Reserve M1 monetary target of 2½ to 5½ percent for 1982. After the summit, the administration's policy remained the same, did it not?

Mr. WEIDENBAUM. The answer to the second part of your question is; yes, of course, we are maintaining our policy, but I would not describe——

Representative REUSS. Not, of course.

Mr. WEIDENBAUM. I say, of course——

Representative REUSS. It could have changed, but you are saying it did not.

Mr. WEIDENBAUM. That's right, but I would not describe the policy in the words you used.

Representative REUSS. You have answered that the policy was unchanged. Now please correct my statement of the policy. I was not trying to play games. I thought I was stating what it was. Wherein did I goof up?

Mr. WEIDENBAUM. As we see the policy, it is a four-pronged approach involving——

Representative REUSS. There are many other things, but it does contain——

Mr. WEIDENBAUM. Supply-side tax cuts are a fundamental feature.

Representative REUSS. I did not mention regulatory policy or energy policy or a lot of other things, because my main question you answered, which was that our policy, our domestic economic policy was the same after Versailles as before.

Mr. WEIDENBAUM. That's right.

EXCHANGE MARKET INTERVENTION

Representative REUSS. Next question. Our policy with regard to international exchanges prior to the Versailles summit was that the United States would intervene in exchange markets only to combat disorderly conditions.

Mr. WEIDENBAUM. That's right.

Representative REUSS. Was that changed at the summit?

Mr. WEIDENBAUM. No; it was not. That was a policy. In fact, those are the words used in the IMF articles that this Nation is a signatory to. What did occur shows the open-minded nature of this administration. We suggested at the summit a comprehensive study of how effective is government intervention in foreign exchange markets.

Representative REUSS. Pending that study, there has been no change in policy.

Mr. WEIDENBAUM. We see no reason for such change in policy.

Representative REUSS. I should add, that is fine with me, and I'm not putting in value judgments, I am just trying to get through my mind whether there was any change or not, and the answer is no.

Mr. WEIDENBAUM. That's right.

NO PROGRESS ON EXPORT CREDITS TO SOVIETS

Representative REUSS. The third and last area, summit area, that I want to inquire about is, that prior to the Versailles summit our European allied participants in the summit with respect to their export credit policy toward the Soviet Union had no finite-stated limits on the kind of export credits which they could give. That was not changed at the summit, was it?

Mr. WEIDENBAUM. To my knowledge, they had no finite limits; that's right. The communique does not contain any finite limits.

COVER-UP OF RECESSION FORECAST

Representative REUSS. Let me now turn to your testimony of this morning, particularly to the point you made where you say, "Yes, we are in a recession, but that was to be expected, and it was anticipated." And later, "In fact, the unpublished work sheets supporting our economic white paper of February 18, 1981," that is the President's program for economic recovery, "estimated two consecutive quarters of negative growth, which corresponds to the common rule of thumb for calling a downturn a recession."

My reaction to that is, now you tell us. Was there any hint or suggestion in the President's economic program that his trusted advisers had found a recession ahead on the horizon?

Mr. WEIDENBAUM. You appreciate, no administration releases the quarterly numbers. We were just maintaining tradition. On the contrary, since my very first press conference, our first week in office in the White House, January 1981, I alerted, as best I could, the American public to—if I can recall the exact phrase, a soft, soggy year ahead.

Representative REUSS. When were you confirmed, Chairman Weidenbaum?

Mr. WEIDENBAUM. Sometime in February, but the press conference——

Representative REUSS. With all due respect, and I have always listened to you with attention and respect when you were in office and out of office, but when you were making that statement in January about sogginess ahead, you were a candidate for the Chairmanship. Where in the President's lengthy February 18, 1981, white paper, which I hold in my hands, is the dreadful truth about the two consecutive quarters of negative growth revealed to the American people?

Mr. WEIDENBAUM. I was Chairman-designate of the Council of Economic Advisers, and I was exercising the full office, let me assure you of that.

Representative REUSS. Now returning to my question, which refers to the several hundred pages of the white paper of February 18, 1981, and would you tell us whether there was any disclosure by the President that his economic advisers in their unpublished work sheets had found two consecutive quarters of negative growth which corresponds

to the common rule of thumb for calling a downturn a recession. Is it in there?

Mr. WEIDENBAUM. Very frankly, there is a lot of unpublished data which is prepared to back up that lengthy document. What is in there is a very free, full and frank analysis of 1981, showing a modest 1 percent growth in real GNP for 1981.

Representative REUSS. 1.4 percent.

Mr. WEIDENBAUM. 1.1 percent was the number I recall.

Representative REUSS. I refer you to page S–1 of the white paper, "Economic Assumptions, 1981 Estimate Gross National Product 1.4 Percent".

Mr. WEIDENBAUM. I refer you to the part that the Council of Economic Advisers did, which is the up front part.

Representative REUSS. I have the greatest respect for the Council of Economic Advisers, but traditionalist that I am, I also look to the President to lay it on the line, and what he told us was 1.4 percent.

Mr. WEIDENBAUM. On the contrary, you are looking at the fourth quarter over fourth quarter data. In the President's major statements, we highlighted the year over the year data which is 1.1 percent.

Representative REUSS. I refer you and the press, again to page S–1 of the "Economic Assumptions" white paper for their objective judgment; whether a word was said about whether this was fourth quarter over fourth quarter or year over year——

Mr. WEIDENBAUM. Let me emphasize, referring back to figure 1, which has been inserted in the record at an earlier point, a very modest 1 percent growth over all in the year, for the year as a whole. Of course, that scene was repeated frequently, and in a series of testimonies that I gave in public to a variety of congressional committees, beginning with March, the very next month, I pointed out the possibility of one or more quarters of negative growth in the period ahead. We tried to provide as free, full, and frank candid an explanation of that adjustment as possible.

Representative REUSS. My time is up but I will return to the point at which you leave us which is there was a continuing level with the country and the Congress on future growth. I would come back to that.

Senator MATTINGLY. The figures I believe we have, Mr. Weidenbaum, on that is we were talking about a GNP growth of a difference between 1.1 versus 1.4 percent, either one of which would have been soggy growth, I believe.

Mr. WEIDENBAUM. Yes, sir.

Senator MATTINGLY. The question today is: Is Reaganomics working? We have heard a lot of criticism from everybody on the Joint Economic Committee, but Herb Stein recently had an article in the Wall Street Journal where he said, in reference to the Democratic alternatives, that they have become clearer and clearer, and less and less attractive.

In his article about the suggestions by some other policymakers which had been tried for the last 20 years and that had failed, he said:

> A prescription for reviving inflation by abandoning what seems to be working—monetary restraint, and yearning for what never has worked—incomes policy—and a program that ignores the expenditure side of the budget is not an intellectually defensible or politically realistic way to reduce budget deficits.

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I would like to have his article inserted at this point in the record. [The article referred to follows:]

[From the Wall Street Journal, Friday, June 4, 1982]

REAGAN ECONOMICS—COMPARED TO WHAT?

(By Herbert Stein)

I have not been enthusiastic about Reagan economics. I am not in favor of a constitutional amendment requiring school children to pray for a balanced budget. I think the 1981 tax cut was much too big and the consequent deficits too large. From time to time the administration has, in my opinion, nagged the Federal Reserve too much. The Reagan team has made excessively optimistic forecasts, which first buttressed the case for the excessive tax cut and then led to disappointment.

However, I am feeling much more comfortable with Reagan economics today. That is only to a minor extent because of anything the administration has done. It is overwhelmingly because the alternatives have become clearer and clearer—and less and less attractive.

After all, one cannot choose federal economic policy a la carte. One has to choose *table d'hote*. And compared with the Reagan table, what the other *hotes* have to offer is no appetizing.

The most obvious example is what happened on Terrible Thursday, when the House turned down all the budget resolutions. How one looks at that depends, of course, on one's priorities. Mine run like this:

1. To defend the country.
2. To get the inflation down by slowing monetary growth.
3. To reduce budget deficits in order to promote growth by increasing the availability of savings for private investment.

Compared with the alternatives, the program the President supported—the Michel-Latta budget in the House and the Senate resolution, which are not far apart—was closest to my priorities. By alternatives I mean not only the other budgets that were being considered in the House but also the possibility of no budget at all.

A GLOOMY OUTLOOK FOR DEFENSE

The clearest difference was in defense. The Michel-Latta-Senate proposal would have cut defense spending in 1985 by $10 billion from the original Reagan budget. Sixty-four House Republicans bolted on this and supported a bigger cut in defense. All the other plans would have cut it by more. The Jones package in the House would have cut it by $22 billion 1985. Even the respected Extet—six ex-secretaries of Treasury and Commerce—recommended a cut of $25 billion in 1985. The alternative that some urged upon the President—that he avoid commitment to any budget package and confine himself to vetoing excessive expenditures—would probably yield the worst defense outcome of all. The President cannot veto failure to enact a defense appropriation.

With respect to my second priority, the control of inflation by monetary restraint, the general thrust of Democratic policy in Congress is in the wrong direction. The budget resolutions sponsored by Democrats included instructions to the Fed to revaluate its policy—meaning to ease up. Some Republicans are also on that track, and some want to return to the inflationary and discredited policy of trying to stabilize interest rates. Despite some wobbles, and criticism of details, the administration has been more supportive of the restrictive monetary policy than any other actors in the political process.

On paper, all of the budget proposals provided for federal deficits of $100 billion to $110 billion in fiscal 1983, $70 billion to $80 billion in 1984, and $30 billion to $50 billion in 1985. But this decline in the deficit was more likely to eventuate, and more credible, in the Michel-Latta-Senate proposal. The difference is that the Michel-Latta-Senate budget relied more on cutting nondefense spending and less on revenue increases. The President would be more able to enforce the nondefense spending cuts by his vetoes than he would be to bring about a large increase of revenues. The willingness of the Democrats in Congress to incorporate large revenue increases in budget resolutions does not mean that when they got right down to it the Ways and Means Committee would be able to agree on a bill that raises much revenue. The picture of the congressional

Democrats as happy tax-raisers is incorrect. They have been glad to spend the revenues that inflation generated but reluctant ever to raise tax rates explicitly.

I have, of course, been comparing the Reagan-supported budget mainly with ideas of congressional Democrats, and that may be unfair. But I do not get a different picture when I look at what might be called the intellectual leadership of the Democratic Party. I refer, for example, to the Center for National Policy, formerly the Center for Democratic Policy which, despite what one might have thought, is, in its own words, "independent of any political structure or faction."

With the assistance of an advisory board of 315 persons, ranging alphabetically from M. Bernard Aidinoff to Raul Yzaguirre, the CNP has produced a series of "Alternatives" for the 1980s." The most relevant of these is No. 4, "Economic Choices: Studies in Tax/Fiscal Policy," which contains articles by Walter W. Heller, Richard Musgrave and Francis M. Bator. The basic thesis of these papers is that the effort to curb inflation by monetary restraint is too costly in unemployment and that we need "some kind of mechanism to slow down wage and price increases" (less delicately called controls). Along with a more rapid growth of the money supply we need a smaller deficit in 1983 and after. That is to be achieved by large tax increases. Oddly for a study of fiscal policy, there is no reference to the expenditure side of the budget, except that in addition to the deferral of the 1983 income tax cuts and of indexing. Mr. Heller thinks the deficit-reducing package should include "other judicious tax adjustments and budget cuts." He spells out some of these "judicious" tax (raising) adjustments but no budget cuts.

That is other worldly. It is a prescription for reviving inflation by abandoning what seems to be working—monetary restraint—and yearning for what has never worked—incomes policy. And a program that ignores the expenditure side of the budget is not an intellectually defensible or politically realistic way to reduce budget deficits.

TOASTERS BEFORE MISSILES?

Much the same comment may be made about the most recent of Brookings's annual reports on the budget: "Setting National Priorities—The 1983 Budget." The report contains, as always, much useful information and analysis in the small. But on the larger questions of priorities it runs quite counter to mine. It proposes larger defense cuts and smaller nondefense cuts. (The Reagan nondefense cuts are regularly described as "sharp," "drastic," "slashes" and so on, though the report must be given credit for expressing sympathy for the idea of limiting the indexing of Social Security.) It recommends more monetary expansion and it nostalgically and ritually longs for an incomes policy.

There is said to be a more modern alternative to Reagan economics than that represented by these veterans of Kennedy-Johnsonism. Its leading thinker and spokesman is said to be Lester Thurow. But I get no solace from the prospect of a Thurovian economic policy. Mr. Thurow thinks it is more important for the U.S. to lead the world in toasters than to lead the world in missiles, a conception that I find staggering.

Even at a less global level, Mr. Thurow is worrisome. He is full of good specific ideas about taxes and other things, but I cannot see what kind of general system emerges from his ideas. Or perhaps I can see, but I don't like it. He is an example of John Jewkes's proposition that to look at every case on its merits is not to look at the merits of the case. Mr. Thurow's favorite line is that the slowdown in U.S. productivity growth is due to a thousand cuts which need to be cured by a thousand Band-Aids—meaning a very large number of separate, government programs. This is a road map for getting into trouble, not out of it, even if the thousand Band-Aids were to be applied by a thousand MIT professors—which they surely wouldn't be.

So while I shall continue to grumble about aspects of the President's policy—which is the outsider's privilege and even his duty—I will also acknowledge and insist that it is superior to any alternative that has been offered. It is also superior to what now seems the probable result of the budget debacle in the House of Representatives.

Senator MATTINGLY. You may want to comment on that statement.

Mr. WEIDENBAUM. I think my distinguished predecessor, Herbert Stein, has written a very wise piece of analysis. The point that I would emphasize is simply that compared to any alternative that has been

suggested the Reagan economic program clearly is the most sensible approach to dealing with the economic problems that have been facing this Nation. And that progress is already visible.

Senator MATTINGLY. We talk about laying it on the line. We ought to lay on the line the proposals that are out versus alternatives that are a little smoky, to say the least.

You know, if somebody has got a better program, it would not be a bad idea for them to come forth with it.

I would like to clarify some other points. I would like for you to clarify them versus the budget.

Mr. WEIDENBAUM. If I could say for just a moment, Senator, when they talk about incomes policy. I can only describe that as the hair of the dog that bit you remedy. That is the kind of economic policy that got us the escalating inflation.

Senator MATTINGLY. When you and I were talking before we ended with the conversation about cutting the budget.

I would like for you to clarify a little bit; I have not noticed it going down. The budget that we are projecting that passed the Senate is larger than fiscal year 1982. Fiscal year 1982 is larger than fiscal year 1981.

I do not know—we are not cutting the budget; are we? It seems to be that we are trying to slow down the growth of that steam engine.

Mr. WEIDENBAUM. Yes, sir. There's no question about it. Expenditures will be higher next year than this year—higher in 1984 than 1983—but if we can substantially slow down the growth of that spending, we will get a closer alinement between revenues and spending and reduce the share of Government in our economy.

Senator MATTINGLY. The other thing we have been talking about is—you can call it revenue enhancements, tax increases or whatever you may want to talk about—what is the position of your office?

What's the administration's thinking about the new revenues that we are talking about; are these going to be new taxes or are they going to be closing up loopholes and creating more equity?

And there is a difference.

Mr. WEIDENBAUM. Yes; indeed. First of all, we strongly believe that major efforts to reduce deficits should be on the expenditure side.

To the extent we responsibly can, we need to cut outlays, and if that does not produce the desired deficits estimate, then somewhat reluctantly, of course, we need to look at the revenue side. And here to date the recommendations of the administration have been the modest ones dealing with, as you indicated, closing loopholes rather than instituting new taxes.

And, of course, we feel very strongly that the across-the-board reductions in personal income taxes enacted by the Congress last year should continue—should not be cut back, should not be deferred. They are an essential element of any sound long-term tax program.

Senator MATTINGLY. Are revenues coming in faster now than projected?

Mr. WEIDENBAUM. My estimate is that the deficits for this year will be about $100 billion, and that the first half of the year revenues came in a bit faster than anticipated. And that the second half of the year they will come in more slowly than anticipated.

I have gotten six different explanations for that. I'm not sure if any one of them fully explains—partially, I think, it is an example of taxpayer rationality. We have increased the penalty for late payment, for under payments. That has served—I would suspect—as a very useful incentive to get people to pay their taxes more promptly.

That will not affect the total amount received, but it will push up into the first half of the year.

Senator MATTINGLY. Congressman Reuss made a comment about the summit. One comment he brought up was about the trade policy issue.

As you know, the conference begins in November—the GATT conference at which they will be debating and discussing a lot of inequities that have been created over the last few years.

I think that was probably discussed, you know, briefly at the summit. I just read something about it. I think that here we see the former policies that we have used in our country have not worked in our favor, and the new policies or what policies the foreign allies of ours have used have been to the detriment of the exports of this country. And if I'm not mistaken this is the first time in eight recessions that the net exports have declined.

I think it has been due to trade policies brought on by other countries. I think we are going to see either legislation by the Congress or acquiescence by our trading partners to create equity.

Now, I do not know what your opinion is, or if you have any new ideas on that.

Mr. WEIDENBAUM. Our basic opinion is consistent and clear. There are too many obstacles to the flow of trade and investment around this world. And the basic answer is not to erect in turn our new corresponding set of barriers to trade and investment, but to convince our friends and allies and competitors around the world that we are all better off if they reduce the very substantial array of barriers to the flow of trade and investment.

We have been sounding that theme at the OECD meetings and at summits; and we, of course, will do that at the ministerial meeting of GATT this fall.

In all candor, Senator, I also have to remind the subcommittee that we have a few trade investment barriers ourselves. When I am overseas discussing these matters with our foreign friends, they do not hesitate to remind me of the other side of the coin, that is, our obstacles to their exports.

Good economics does not mean competition to erect trade barriers but, if anything, a competition to reduce those barriers.

It is not to be done effortlessly; it is going to take a lot of convincing, I think, of people—nations faced with rising protectionist sentiments.

And here we get back to general economic policy. It is quite clear that protectionist sentiment rises during recession and recedes during recoveries.

Senator MATTINGLY. Yes, I think the trade policies, no matter what we may call them, may turn into utilization of the mirror theory. We need to look in the mirror, and our trading partners need to look in the mirror. I think that is how we will arrive at equity in trade policy for this country and other countries.

REQUEST FOR SUPPRESSED RECESSION FORECAST

Representative REUSS. Thank you. Let me return to the subject we were pursuing. Would you hand us—because I want to include in the record, Mr. Weidenbaum, the unpublished worksheets supporting the economic white paper of February 18, 1981, which you referred to in your written testimony?

Mr. WEIDENBAUM. These of course—I am not in a position to provide those——

Representative REUSS. Can we have them, or do I have to proceed under the Freedom of Information Act to get them? You have referred to them in your testimony; you cannot dangle them before us and then fail to let us look at them.

And the press is interested too.

Mr. WEIDENBAUM. Excuse me.

Representative REUSS. The press is interested too. They would like to see them.

Mr. WEIDENBAUM. I will respond as completely as I can.

Representative REUSS. Great! Can I have the unpublished worksheets which show the two consecutive quarters of negative growth?

Mr. WEIDENBAUM. I will respond as completely as I can.

Representative REUSS. Mr. Chairman, we are faced with a constitutional crisis here: The witness comes in and brags about how prescient the Reagan administration was in its private unpublished papers.

Meanwhile, Congress and the country, we are being told by the President in his economic program of February 18, 1981—that is the white paper previously referred to—and I quote: "The program we have developed will revitalize economic growth, renew optimism and confidence and rekindle the Nation's entrepreneurial instincts and creativity," and we were told real GNP would go up 4.2 percent in 1982.

And now we are told the proclaimer of these glad tidings, which lulled Congress into the belief that we were not facing a steep recession, had available unpublished worksheets which estimated two consecutive quarters of negative growth.

And the witness is now refusing to produce them.

Senator MATTINGLY. I am sure the witness did not bring his file cabinet with him. He could probably produce——

Representative REUSS. I will ask the witness. Are those papers here in the hearing room?

Mr. WEIDENBAUM. No, they are not.

Representative REUSS. How long will it take—and I can provide limousine service to get them up here.

Mr. WEIDENBAUM. Congressman Reuss, I had no idea I was going to create a constitutional crisis—to use your phrase.

Representative REUSS. Well, you did create one, sir. How about getting those papers up here?

Mr. WEIDENBAUM. Let me assure you of one basic point: Any worksheets—and there are lots and lots of worksheets——

Representative REUSS. I just want to see these two on which you predicate your statement that you and the administration knew all about the looming recession.

Mr. WEIDENBAUM. If I may continue, there are lots of unpublished worksheets. The key point that I want to assure you: All of those un-

published worksheets are totally consistent with the numbers published in that white paper.

Representative REUSS. I am pleased to have that assurance. The press, nosv as always, would just like to see those unpublished worksheets which estimated two consecutive quarters of negative growth.

What quarters were those, by the way?

Mr. WEIDENBAUM. In 1981.

Representative REUSS. What quarters were those?

Mr. WEIDENBAUM. They were consistent with the modest 1.1 percent real growth for the year.

Representative REUSS. For what?

Mr. WEIDENBAUM. For the year 1981.

Representative REUSS. But the President's economic program, page 25, projected a 4.2 percent real growth rate in GNP for 1982.

Mr. WEIDENBAUM. 1981.

Representative REUSS. 1981.

My question was: What were the two negative quarters?

Mr. WEIDENBAUM. I can do this from memory, the second and third.

Representative REUSS. Do your associates know who helped prepare your paper this morning?

Mr. WEIDENBAUM. I will take credit or blame, as the case may be, I assure you of that.

Let me make a point, with all sincerity, why we don't publish quarterly numbers. Our ability as economists to make annual forecasts is not bad. Our ability as economists to make qua terly forecasts is not very good.

Representative REUSS. I'm not talking about that. I'm talking about the frankness with which the administration informed the country on February 18 of what lay ahead. What was the date of these mysterious, unpublished, workpapers?

Mr. WEIDENBAUM. There's nothing mysterious.

Representative REUSS. What is their date, mysterious or not?

Mr. WEIDENBAUM. I don't remember the date.

Representative REUSS. They would be less mysterious if you would produce them.

Mr. WEIDENBAUM. The point I want to make, if you will permit me, is in a variety of testimonies to the Congress, beginning the very next month. Beginning in March 1981. I alerted the Congress—now, if the Congress was not paying attention, that's not my fault.

Representative REUSS. I hear you. And we would welcome your giving, for the record, all alerts that you achieved during that time.

Mr. WEIDENBAUM. I would be pleased to do so.

Representative REUSS. I also would want—and let's stick to that which I want. I want, in the language of Chairman Weidenbaum, the unpublished worksheets supporting the economic white paper of February 18, 1981, which estimated two consecutive quarters of negative growth.

I want to know the dates of those unpublished worksheets. I want to look at their data. I want to find out—which you cannot tell me, apparently—what two consecutive quarters these were.

And finally, I want some explanation of why, with knowledge of those two upcoming quarters, the administration omitted them from the February 18 white paper which was sent to the Congress.

Mr. WEIDENBAUM. I am giving you the explanation if you will bear with me.

Representative REUSS. But you have to give me the unpublished work sheets.

Mr. WEIDENBAUM. The explanation is very straightforward. No administration has confidence in quarterly numbers to the extent that they will publish them. And we did not have the kind of confidence in the quarterly numbers to publish these. It is that simple.

Representative REUSS. I am listening. And I want to listen carefully to your explanation.

Would you dispatch an associate to your—let me finish—to your office to bring up here those unpublished work sheets—right now—so that they may be introduced in the record?

Mr. WEIDENBAUM. No. I will not. I need to determine—and I'm no attorney—whether, legally, I can provide the information.

Representative REUSS. All right.

When can you get to the Joint Economic Committee your decision, supported by Attorney General Smith's opinion, as to whether or not you are obliged to turn over to the Congress the unpublished work sheets which you have referred to in your testimony here this morning?

Mr. WEIDENBAUM. I certainly cannot commit the Attorney General to any deadline. I do not give him marching orders.

Representative REUSS. When will you submit to the Attorney General, for his opinion, your statement that you have been the subject of a request by Congress for those papers and that you want his opinion as to whether you have to give them up or not?

Mr. WEIDENBAUM. I appreciate your suggestion about the Attorney General. I will take that under advisement. I said I will check that with the appropriate legal staff, whoever that appropriate legal staff will be.

Representative REUSS. I thought the Attorney General was the appropriate legal staff. If you have got some paralegal outfit——

Mr. WEIDENBAUM. This may be a very routine request. There may be all sorts of obvious precedents. I don't presume to provide legal advice to the committee.

Representative REUSS. My time is up. But I renew my request, Chairman Weidenbaum, that you promptly produce for the Joint Economic Committee the unpublished work sheets referred to in your statement.

Mr. WEIDENBAUM. I am pleased to receive that request. And I wish, very frankly, you would not describe some work sheets on the GNP as creating a constitutional crisis. I do think that is a bit overstated.

Representative REUSS. They will create one unless you produce——

Senator MATTINGLY. Your time is up, Congressman Reuss.

Congressman Richmond.

Representative RICHMOND. Thank you, Senator.

Good morning, Mr. Weidenbaum.

Mr. WEIDENBAUM. Good morning, Congressman Richmond.

Representative RICHMOND. This morning I would like to discuss investments.

We have had the pleasure of your company here so many months, and you have been so optimistic about the fact that Reaganomics were

actually working. We were supposed to have bottomed out of this recession in the second quarter. We find that, of course, is a joke. We find the second quarter is even worse than the first quarter.

And I can tell you, Mr. Weidenbaum, that the third quarter is going to be worse than the second quarter.

As you know, the company in which I hold stock is in the business of manufacturing products for other companies, and is a pretty good barometer. And business is not so good. So, let's not lull the American public into thinking that this recession is over.

If you ask me, we are getting deeper and deeper in a recession. And I do not even see the vaguest light at the end of the tunnel.

Now, this great tax give back is an integral part of Reaganomics. The whole theory of Reaganomics is give the American people back their taxes so they will spend money and get the economy going again; correct?

Now, number one, how do you account for the fact that American corporations are spending 50 percent less on modernizing their assets this year than they were last year? With Reaganomics, with the modern tax depreciation plan, and with every type of incentive conceivable to urge American corporations to invest money, how do you account for the fact that investments are off by 50 percent?

And number two, what is your general feeling of the future of investments in general right now with everybody's forecast completely off? We had the Secretary of the Treasury here a few months ago, and he said we were going to bottom out in the second quarter.

Mr. WEIDENBAUM. Frankly, I do not know where you get your information, Congressman Richmond.

Representative RICHMOND. From you.

Mr. WEIDENBAUM. Hardly, because the Department of Commerce, in its most recent report on business investment in plant and equipment, shows, in 1981, the total was $321 billion. And the survey that they made of what private companies say they're going to spend for 1982, the most recent survey is an increase to $345 billion. That is hardly a reduction.

Representative RICHMOND. The orders last month were off 47.5 percent. You read that, as well as I did.

Mr. WEIDENBAUM. No doubt your company——

Representative RICHMOND. Machine tool orders in the United States in general were off 47½ percent.

Mr. WEIDENBAUM. There are many companies that have managerial difficulties, market difficulties. I sympathize, but I do not think we should generalize the performance of the American economy from one or two companies.

Representative RICHMOND. Would you say that the American corporations, the industrial community, are responding to Reaganomics the way the President and his associates expected them to respond? Would you say American corporations are going full blast ahead, modernizing themselves, reorganizing their companies, buying equipment?

Mr. WEIDENBAUM. I suggest you read my prepared statement, where I pointed out the obvious. Business and investment is typically the second stage of an economic recovery, not the first stage.

The Reagan economic program is a long-term program, designed—and I think very properly—to provide the incentives for increasing capital formation.

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Representative RICHMOND. But it has gone the other way.

Mr. WEIDENBAUM. If we learn anything from business cycle history in the United States, the expansion of capital formation does not precede the upturn in consumer spending but follows it.

Representative RICHMOND. With the condition of American industry as it is today, our ailing steel industry, our ailing metal industries in general—as you know, many of our industries are in very sorry condition. I think you and I agree the main problem of the United States today is to begin modernizing our industry and start producing goods in competition with the foreign imports, which we are not doing, for the simple reason that our plants are aged, we do not have the capital. Industry is not willing to put up the capital or borrow money at 18 percent interest. You know, you're talking about 18 percent borrowing, right, with a compensating balance?

Mr. WEIDENBAUM. Some companies borrow below, some above. It is a painfully high rate.

Representative RICHMOND. But a first-class company which can borrow at prime, 16½, is, in effect, borrowing at 18 percent with the compensating balance. How can any corporation in the United States afford to borrow money and modernize their plants?

Mr. WEIDENBAUM. Very simply, because after the effective taxation, they think the return on that investment exceeds their interest cost.

Representative RICHMOND. Mr. Weidenbaum, you know that is not the case. American industry is based——

Mr. WEIDENBAUM. It must be the case. Otherwise, the Commerce Department would not report these surveys that American industry is investing more in 1982 than in 1981.

Representative RICHMOND. That survey is only one of many other surveys. We have other surveys that show that American industry is investing less, and American industry, during the year 1982, is changing its plans downward.

Mr. WEIDENBAUM. That's true.

Representative RICHMOND. We finally agree on something.

And I think, Mr. Weidenbaum, we both ought to agree that as long as interest is effectively 18 percent there is no way for American industry to borrow enough money to buy new capital equipment. You just cannot amortize the capital equipment at those rates of interest.

Mr. WEIDENBAUM. Frankly, that is too extreme a statement to be accurate. It is quite clear that the high rates of interest are a major barrier to capital formation. We're seeing less investment than we would if interest rates were lower. You cannot make the either/or statement accurately. We are not seeing any investment. The $300 billion figure I cited is a very substantial——

Representative RICHMOND. We know the $300 billion figure will not be the case, because American industry is tightening its belt and reducing its expenditures every single day—and we know that—canceling orders right and left. We both read the article about Boeing. Boeing has gotten nothing but cancellations all this year. You read it, as I did.

Mr. WEIDENBAUM. I read the article.

Representative RICHMOND. That is one example of one of the major American corporations that is suffering severe depression due to high interest rates. Nobody can do business at 18 percent.

How are Reaganomics going to work if we don't reduce the interest rates? How are you going to reduce the interest rates if you don't balance the budget?

Mr. WEIDENBAUM. When you mentioned Boeing—I am a former chief economist of the company, so I know a bit about that business—airline traffic is very responsive to the economy. When the economy is in recession, airline traffic turns down very rapidly. But when the economy recovers, airline volume recovers very rapidly. It is what we call a very income elastic market.

Therefore, I am not surprised producers like Boeing have cancellations of orders during a recession. I would expect to see a flurry of orders during recovery.

That is normal cyclical phenomenon.

Representative RICHMOND. There is no question we are in a recession.

Mr. WEIDENBAUM. I said that at the outset of my testimony.

Representative RICHMOND. We cannot say we are going to bottom out in the second or third quarter. I do not see a bottom. Do you?

Mr. WEIDENBAUM. I am watching that.

Representative RICHMOND. You made the statement before in the same chair, we are going to bottom out in the second quarter. The second quarter has come and gone. We have not bottomed out.

Mr. WEIDENBAUM. The second quarter has not gone.

Representative RICHMOND. It is virtually gone and we know it has not bottomed out.

My time is up. Thank you, Mr. Chairman.

Mr. WEIDENBAUM. It is a matter of opinion among economists as to whether the second quarter will be a small plus or a small minus.

Representative RICHMOND. Ask Caterpillar, John Deere, or some of the other corporations whether we have bottomed out.

Senator MATTINGLY. Let me make a clarification. I am sorry Congressman Reuss is gone, but you may not have had the figures with you there, but in 1981—changes in the GNP when you go through each quarter—there were not two successive quarters of decline in GNP. I think it went from 8.6 to minus 1.6 to plus 1.4 to minus 4.5 for a net growth of 2 percent increase in calendar year 1981, so I think that can clarify part of that. And I wish that he were here for just a moment. You know, I joined this committee when I first came to the Congress and I felt like it was an academic forum. It should not necessarily be a media forum.

What we are trying to do is help with the answers. I cannot help but remember him saying three or four times, the media has a right to know about where your files are, which is great, and then he offered to send his limousine, which is obviously at no cost to the taxpayer, to get your information.

We earlier talked about the housing industry, the $5 billion program, trying to fix that spending more Government money. And you know Boeing, they are trying to fix that with a bailout. You know, it seems as if when Braniff went out one day, Boeing came in the next day for a small bailout.

I think today shows one thing in this hearing. I think it shows Reaganomics has got a program on the table, which it has over the last year, and it has another program on the table this year. We did pass a budget this year.

Now, the adversaries, the people who object, if they have got a plan they ought to come forth with it. I do not think it does any good in this forum or any other forum in this Congress to yell and scream about the conditions unless we want to get the interest rates down, and there is only one way to get the interest rates down and that is for everybody to join together in coming up with a budget that is going to decrease spending and also keep the incentives in place.

I think that Congress must pay attention to what happens west of the Potomac River, and you know, you can bring your unpublished work sheets and mail them to Congressman Reuss, that's fine. But I do not think that is the crisis that we have in this country. I think it is jobs, the effort that we put in on revising this budget.

I would like to thank you for coming today.

Mr. WEIDENBAUM. Thank you, Senator.

Senator MATTINGLY. Our next witness will be Prof. James Ramsey.

Professor Ramsey, you have another hearing you have to go to, so if you would like, you may go ahead and make your statement and then we will have questions.

STATEMENT OF JAMES B. RAMSEY, CHAIRMAN, DEPARTMENT OF ECONOMICS, NEW YORK UNIVERSITY, NEW YORK, N.Y.

Mr. RAMSEY. I will try to be very brief, since I believe I am running late. I have another session on the House side.

"Supply-side economics" has become a political code word—a battle cry for some, a source of disparagement for others. Supply-side economics has become "voo-doo economics," except for those of a turn of mind for exotic religions, who then complain of the unfair comparison. Listening to the current debates, one would be excused for believing that there were as many definitions of supply-side economics as there were discussants of the same issue.

It is a return to older ideas which are now postulated in a new form. Really, it is not so revolutionary. In fact, there have been a large number of economists who, for many years, have engaged one way or another in what is now known as supply-side economics, but without perhaps the opprobrium of some of the title. However, there is a key distinguishing characteristic for those people who call themselves supply-side economists or who are concerned about the supply side relative to our colleagues on the other side who have stressed for many years the demand side.

The distinguishing characteristic, I think, is the reemphasis on microeconomics as opposed to macroeconomics, the stress on the activities of the individual and the individual firm, the analysis of what it is that people are actually doing or trying to do and the way in which they make decisions, as opposed to the examination of a cloud of index numbers. It is the recognition that firms and individuals engage in specialization of trade activity, occupation and particularly in risk taking by degree and type. It is also recognition that there are adaptive reactions and that people are not passive acceptors of, for example, Government policy, so supply-side economics, I feel, will not succeed if and until all of those who are engaged in it recognize the point that the issue has to do with the distribution of effects rather more than levels.

Let me illustrate. On the question concerning the passive acceptance versus adaptive reaction, a typical case in point, for example, might be the implementation of the small refinery bias in the entitlements program. In this case, the idea amongst the bureaucrats was that they felt that small refineries were unable to compete on equal footing. They instituted some changes to give them a bias which would enable them to compete, they thought, against the larger refineries and they understood or thought that what would happen is that a small refinery would stay in business and the large refineries would stay in business and everything would be harmonious. Unfortunately, what it did was create an incentive to create small refineries to extract revenues from the largesse provided by the Government procedures.

Another example of this is perhaps a Federal flood plain insurance. Other procedures which, given the humane ideas underlying it of bailing people out from floods that occur on their property, does not recognize the fact that then you have subsidized people to live in flood plains. Consequently, you should not be surprised that they move there and take advantage of the subsidy.

In short, it is a simple lesson which we all recognize but perhaps occasionally needs repeating, that if we pass legislation we must expect people to figure out clever ways to put it to their advantage. On the other side, we talked earlier about specialization of risk by both type and degree. May I give a very brief, concrete example which I think is still extraordinarily important? It has to do with oil exploration, about which I know a little and I think it is a very vital example.

This is an example where firms engage in a very particular form of specialization which is increasingly very difficult. It is a type of specialization which is very difficult to transfer on to someone else. Further, there are different degrees of specialization over a very wide range in terms or different degrees of taking a risk.

Now, recent theory, developments in economic theory indicate the importance of these differences and the importance of differences in types of exploratory areas. On one extreme you have areas where the probability of getting a success is quite high but the expected value of the success is also very small. In other areas you have probability of success in finding oil which is very low but the expected value of the oil when you find it is extraordinarily high. Between these two large extremes you have a whole continuum of alternative trade-offs between risk in terms of the risk and the returns that you are going to get from the oil exploration.

As it happens, you have a distribution of firms by size. Small firms tend to specialize in the low-risk, low-return type of endeavor. The larger firms engage in those sorts of activities which specialize in the higher risk, high-returns sorts of endeavors, and you can demonstrate there is a symbiotic relationship between the larger firms and the smaller firms. The large firms create the preconditions needed by the smaller firms essentially to do their type of exploration.

If, then, we take a policy action which, for example, penalizes risk taking, which tends to penalize larger firms relative to small—for example, the alterations in the oil depletion allowance some years back, the joint bidding ban, the so-called windfall profits which is actually a revenue tax and other such activities, what this does is to shift the

burden of risk against—relatively—the larger firms compared to the small. It also tends to increase the overall level of risk relative to a given set of returns.

The net result is you are going to find, in fact, some rather anomalous results. You may well discover, as is currently happening and as predicted by the theory that drilling may be up, so-called success rates will be up, but that oil discoveries will be down. The results, unfortunately, if it is to be followed, and recently we have taken steps to alter it slightly, but if this were to continue the results would get worse.

The true irony of this is that these outcomes would be regarded as geologically determined, whereas, in fact, they are really a creature of both economics and politics. These ideas could be extended to research and innovation, and indeed, it is the stimulation of research and innovation which is most important to the development of growth if we are to have growth in what we have been talking about today is stimulation of research and innovation, again the concept of risk and return comes into play.

One of the problems we have observed in the comparisons, for example, between the United States and foreign countries, is that in a sense, our innovation rate has been lagging. Our ability to patent has been falling behind what it was before. We should recognize that if you penalize returns, if you increase the degree of risk that firms face, you will still get innovation but it will be a sort of a piddling type, M_1 sort of innovation where you make minor changes to existing products. But if you want the really big breakthroughs, then you have to encourage a high degree of ability to take risk, which frequently means you must avoid trying to tax a sudden, big, massive breakthrough to pay for all of the small failures that accumulate over a long period of time.

My next point, to illustrate the general ideas that I have been trying to put across concerning the distribution and also the use of saving investment, is a problem that we have faced, and Britain, too, has faced in the same sort of manner—what one might call productive and nonproductive expenditures on investment goods—between the difference between buying GM stock versus buying rare wines, antiques, houses, or antique cars. One suggestion to consider, to throw out as an illustration, would be to deduct from taxable income all moneys invested in new securities, new issues, new capital for creation of new plant and equipment, down to the creation of a new Mom and Pop grocery store. This would be the personal equivalent to the corporate idea of retained earnings for tax purposes.

In other words, if you invest the money in new securities, you try to build a new building, you create new wealth while you are doing that and that income would not be taxed, and when you return it back in income which you wish to spend, then it would be taxed. This would tend to reestablish some of the differences between the United States and Europe where the Europeans rely very heavily on the value-added tax. The point of the value-added tax is that it taxes consumption, rather than savings.

The point is merely that this is a device which may be a very bad one, but it is a suggestion for you to consider to encourage savings and therefore investment—by increasing the supply of savings—as op-

posed to encouraging consumption, which has been the traditional path to increasing wealth in this country since the so-called "Keynesian Revolution."

Last, we might comment very briefly on what is the penalty of a deficit. With the deficit we have essentially four alternatives. The first one is to monetize it, and I think that enough has been said about that so I will not even bother mentioning that procedure. The second issue, we could eliminate a deficit by raising taxes. We could eliminate deficits lowering expenditures. And finally, we could capitalize the deficit by going into the capital market and funding it.

Comments I made earlier relate to this because of the different ways in which we handle the deficit and we are forced to take one of the four issues leads to vastly different results on individual behavior in the way in which the economy functions.

If we were to raise taxes, essentially what we are doing is to lower the consumption of the group for whom the taxes are raised. We also lower to some extent their savings, since they are paying extra taxes, although it is in the ratio of 9 to 1 on average in order to pay for those people who are getting extra income.

I will ignore the humanitarian comments as to why we should have transferred income from one people to another, since this cuts across the entire set of arguments.

On the other hand, we can lower expenditures, which would tend to raise incentives insofar as by the way the poor ever managed to get the taxes that are raised from the people who are paying them.

But it would tend to maintain the savings rate, so there is a trade-off between raising taxes and lowering expenditures, as to what the effect would be in the supply of savings and therefore on the ability to carry out investment.

The last issue is the most important one: What if instead we financed the deficit which is paying for increased consumption by a certain group of the population through transfer payments by going on to the market and raising the funds through the normal securities market area—the use of Treasury bills?

If we were to take this approach, the effect would be different. Theoretically we can say that the entire effect of covering a certain deficit which is going into transfer payments would now be placed upon the savings generated by the private market.

Instead of only a portion—roughly one-tenth—going off to the marketplace for savings, now we would have the entire amount going into the private marketplace.

So much for theory. What is the practical implication of that? If the deficit—Federal deficit—is very small relative to, say, total gross domestic investment, then we are talking about small amounts.

While theoretically it has an effect, it is not very important. On the basis I—roughly—made a few calculations, which I brought with me today. Just selected some dates essentially up to 25, 30, 35, every 5 years, to indicate the ratio between the Federal deficit and the net private domestic investment.

These figures, by the way, were obtained from the Council of Economic Advisers. So if anyone wants to check up on it, they know exactly where to go.

Ask Murray Weidenbaum: during the war—during 1940 through 1946—the ratios were 0.76 and 0.96—about three-quarters. You know, the deficit was about three-quarters of net private domestic investment in 1939–40. And about nearly even to it in 1946, coming out of the Second World War.

During the 1960's and into the 1970's the ratio was very small: it was 1 percent, 3 percent, and 5 percent. And indeed we had a small surplus in 1960.

So those amounts are really very small and had no effect. While one could theoretically talk about the crowding out that the deficit financing runs, it was really a very small amount of money and we could forget it.

The situation, post-1975, however, is very different. It is actually post earlier in the 1970's. In 1975 the figure was 0.97; that is, the deficit was roughly equal to the total amount of private domestic, net domestic, investment.

In 1980 it had fallen to about 0.55, and in 1981 it had fallen to about 0.45; given the figures that I quoted. I do not want to stress the actual numbers so much as just to point out that the comparison of the 1970's into the 1980's relative to the figures which prevailed during the 1950's and 1960's was that we had shifted to an enormously larger increase in the size of the deficit relative to net private domestic investment.

Under these conditions then the crowding-out problem is a factor which has to be taken into account. In other words, it is now a serious issue.

If one cares to view the matter in this, one can say that the choice is no longer for guns for defense and butter today, but is between welfare today and perhaps even more welfare tomorrow.

That concludes my very brief comments.

Thank you.

[The prepared statement of Mr. Ramsey follows:]

Prepared Statement of James B. Ramsey

"Supply-side economics" has become a political code word - a battle cry for some, a source of disparagement for others. Supply-side economics has become "voo-doo economics", except for those of a turn of mind for exotic religions, who then complain of the unfair comparison. Listening to the current debates, one would be excused for believing that there were as many definitions of supply-side economics as there were discussants of the issue.

However, for me the concept has little mystery and is mostly a pedestrian return to earlier concerns in the economic literature. For some economists, at least, the slogan of supply-side economics simply indicated the obvious notion that economic conditions have an impact on an individual's productive efforts and willingness to take risks, on the organizational effectiveness of firms, and on the

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efficiency of markets. Supply-side economics is merely the "other blade" to the Marshallian economic scissors of demand and supply. The phrase is needed merely because macroeconomic analysis had become single-mindedly focused on demand. Thus, in this light, supply-side economics is an almost trivial recognition of the importance of the "other half" of economic analysis - supply versus demand.

To be fair, supply-side ideas had been anticipated by a number of scholars, for example, at the Poverty Institute in Madison, Wisconsin, where empirical and theoretical research was done on the labor supply effects of a negative income tax. All of those who have argued in the past about the inefficiency of regulatory attempts were also supply-side economists, but without the pejorative label.

Moreover, a key differentiating characteristic for economists more concerned with supply conditions as opposed to demand was the recognition that the essence of the problem was microanalytic, not macro; one had to pay close attention to individual and firm behavior; to be concerned about differences between individuals and firms, one could not safely ignore individual characteristics within an aggregate cloud of index numbers. To the supply-side oriented economist, more than his demand-side colleague, large scale macro aggregates and the ubiquitous presence of index numbers were impediments to analysis, not a benefit. The understanding of differential

effects of any action across individuals and firms, the recognition of specialization in activity and risk-bearing by different individuals and specific firms, and the realization that agents react to changes adaptively, not passively, distinguishes the supply-side enthusiast from his contemporary demand-side devotee. The key behavioral elements, therefore, to be kept in mind are the importance of individual differences, the role of specialization of activity, and adaptive reactions. Let us explain these abstract ideas in the context of practical examples.

Consider first the notion of adaptive reaction, as opposed to passive acceptance. Bureaucrats almost always assume economic agents behave in the latter manner. The incorporation of the small refinery bias in the Entitlements program is a classic example. A potential problem was perceived by the Federal Energy Office (FEO) in that small inefficient refineries were thought to be unable to compete under the entitlements program, so the FEO gave small refineries a competitive edge. The "passive acceptance" expected by the bureaucracy was for existing small and large refineries to continue to operate as before and in harmony. The recognition of "adaptive reaction" is to recognize that one can make a fortune by opening or re-opening small refineries whose sole claim to financial viability is the government's largesse to the inefficient.

Another example is Federal flood plain "insurance" and

rescue efforts whereby people are subsidized to live in flood plains. The expected passive reaction is to benefit the existing flood plain incumbents when the humane legislation is passed; the unexpected adaptive reaction is to create a new demand for living in flood plains at taxpayer expense.

The other ideas of individual differences and specialization can be exemplified most easily in terms of the economics of exploration. The example also illustrates a problem of considerable contemporary concern.

Recent economic theory, see Ramsey (1981), shows that in the market for the exploration of oil reserves, it is important to recognize that there are important differences in the types of areas which can be explored. At one extreme, there are areas where the probability of a discovery is very high, say one in two, but the expected value of the discovery will be low. At the other extreme, the probability of a discovery may be very low, say one in a thousand, but the expected value of the discovery is very large.

It can be shown that small exploration firms tend to specialize in the former areas and large firms in the latter, that is, small firms use techniques best suited to going for the high probability of discovery, but low expected value, areas and large firms for the low probability, but high expected value, areas. The reason for the difference lies

in the different reactions to risk and probability of bankruptcy between the small and large firm with any given pattern of exploration activity.

Now let us suppose that we penalize risk-taking and tax large firms proportionately more than small firms, for example, by altering the oil depletion allowances to disfavor large firms, by adding a so-called windfall profits tax, by banning joint bidding, etc.; then such actions will shift the distribution of exploration activity away from the high risk, high expected return areas toward the relatively low risk low return areas.

The practical and currently observed domestic U.S. outcome is that while drilling activity may increase and average success rates rise less oil is discovered. Far worse is that over time discovery rates and amounts will both fall. The irony is that such results will be viewed as geologically determined, whereas in fact the result is purely political and economic.

This example is, I believe, an important and clear example of the danger of viewing aggregates only and ignoring individual differences and specialization. An "exploration firm" is not a single homogeneous entity. Total foot wells dug is not a useful measure of exploration activity if one does not know the distribution of wells by exploratory area, and so on. Total aggregate expenditures on exploration is even less useful. Policies which do not recognize the

distributional differences can be disastrous as in the case of oil exploration.

The main lesson is that the aspects of fundamental importance are more involved with the composition of the aggregates rather than the levels. Supply-side economics will never be successful until this idea is grasped in all its aspects and ramifications.

The basic point being made is easily extended to research and innovation. The ostensible reason for the pursuit of supply-side economics by this Administration is to generate growth, but now one can see that to understand how to stimulate research and innovation and thereby generate growth, one must look deeper than the levels of a small number of macro aggregates. Merely increasing the funds for research will do little. What is needed is to consider appropriate methods for encouraging risk-taking by individuals and firms. What is needed is to recognize that one can innovate relatively risklessly by not being very adventurous and merely making minor improvements to existing products. But, to get the big breakthroughs and create the industries of the future one needs to encourage risk-taking. Unfortunately, conventional modern tax structures tend to mitigate high risk-taking, especially for small entrepreneurs. This is in part because only gains are taxed and losses in previous years cannot be offset against income in future years. A large firm with a

continuous stream of projects is less affected than the entrepreneur with a single good idea. Thus, a realization of the multiperiod nature of research endeavors could lead to useful tax reforms in this area.

An example of an alternative method of encouraging productive investment is to encourage the supply of savings to such endeavors. One of the deficiencies with the current systemis that the productive and non-productive uses of savings are treated equally. Alternatively, suppose that individuals could deduct from their taxable income all sums invested in venture capital, new issues of securities, and new bonded indebtedness; in short, we extend the notion of taxation of only "retained earnings" from corporations to individuals. The result would be a lowering of the cost of providing savings to risky endeavors and productive enterprises. Saving per se will be encouraged, but more importantly, saving will be channeled away from the purchase of old houses, antiques, rare wines, and existing art, towards new ventures and rebuilding old firms. If one considers this approach in contrast to a simple reduction in taxes to stimulate productive investment, the latter has virtually no effect. A simple reduction in taxes will on average affect only the one tenth of income saved. In the proposed scheme, the entire tax reduction is brought to bear exclusively on encouraging savings, not consumption as well, and in particular it discriminates between types of use of

savings. Further, the relative impact of the scheme is is greater the greater the level of personal taxable income.

We can now turn this discussion to a topic of contemporary and high interest to this Committee: what is the penalty of a deficit. Let us ignore the common expedient of monetizing the debt and thereby raising inflation - enough words have been spilled in that battle already. We have three major alternatives - fund the deficit in the capital markets, increase taxes, lower expenditures. In order to simplify the discussion of the major point assume that the government deficit is due entirely to the payment of income transfers greater than current tax receipts; since such payments are now the major and fastest growing Federal expense, this assumption is not unduly unrealistic. We ignore the humanitarian argument for income transfers since they apply equally in all cases. If we increase taxes we will reduce both the consumption and saving of the taxed in roughly the proportion of nine to one, while increasing the incomes of the recipients; essentially income is transferred from the productive and earning to the non-productive and non-earning which on balance tends to lower overall effort and productivity.

The next alternative is to reduce expenditures, which in essence does the opposite, i.e., we tend to raise, by direct effects at least, overall effort and productivity by reducing the subsidy of the non-earning and less productive.

The third alternative is to finance the deficit which means raising money in the capital market. We now have a very different set of tradeoffs. With this approach, savings are used entirely to subsidize the consumption of the income recipients. For example, in the scenario of raising taxes nine tenths of the income recipients gain comes from reduced consumption of the taxed. But in the deficit scenario, savings alone must bear the entire burden. Consequently, deficits bear disproportionately on the use of voluntary savings and thereby lower the amount available for productive investment.

So much for theory, what of reality? Consider Table 1, which shows the ratio of the historical record of governmental deficits to net private investment. The object of this exercise is to see if the theoretical argument has any empirical relevance. The answer from Table 1 is that during the Great Depression and the war yes, but not afterwards, not at least until the mid-seventies. It is most striking that only recently have deficits become an obvious and very clear burden on the financial markets, the like of which has not been seen since the war.

We may conclude that while deficits could be ignored during the '50's and '60's, at least with respect to the impact on the financial markets, they certainly cannot be so ignored today. With deficits matching one-half of the whole of net private domestic investment, the impact on private capital

formation is clearly enormous and, ironically, the generation of future welfare demands for income transfers will be increased. If one cares to view the matter in this manner, the choice is not between guns for defense and butter for the poor today, but between welfare today and even more welfare tomorrow.

Table 1

Ratio of Federal Deficit to Gross and Net Private Domestic Investment for Selected Years[a]

Date	Gross Private Investment (in billions)	Net Private Dom. Invest. (in billions)	Deficit (in billions)	Ratio Def/GPI	Ratio Def/NPI
29	16.2	6.5	+0.7	+0.04	+0.11
33	1.4	(-6.0)	-2.6	-1.86	-
39	9.3	.6	-3.9	-0.42	-6.5
40	13.1	4.1	-3.1	-0.24	-0.76
46	30.7	16.6	-15.9	-0.52	-0.96
50	53.8	30.3	-3.1	-0.06	-0.10
55	68.4	33.6	-3.0	-0.04	-0.09
60	75.9	29.6	0.3	+0.004	+0.01
68	113.5	57.5	-1.6	-0.01	-0.03
70	144.2	56.2	-2.8	-0.02	-0.05
75	206.1	46.8	-45.2	-0.22	-0.97
80	395.3	108.1	-59.6	-0.15	-0.55
81	450.6	129.1	-57.9	-0.13	-0.45

a These figures were obtained from Tables B16 and B73 in the Economic Report of the President, U.S. Govt. Printing Office, Washington, D.C. 1982.

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Senator MATTINGLY. A couple of brief questions, Mr. Ramsey, what is your opinion of the efforts to stimulate housing by Government subsidies to buyers of new homes?

Mr. RAMSEY. I believe entirely with what I remember hearing Mr. Weidenbaum state. I think it is a ghastly mistake.

It will be almost entirely dissipated in terms of the increase in the price of housing over what it otherwise would have been.

It will do in fact very little, I think, to genuinely stimulate investment. It provides the wrong signals—again, it is a bailout which should not be there. It is attacking the wrong enemy.

The wrong enemy, in fact, has to do with regulation Q and the inability of the savings and loan associations to compete in a market for which the interest rates are far beyond those that were envisioned when regulation Q was originally set up.

That is the real issue. Eliminate regulation Q, allow savings and loans and banks to compete for deposit, and to compete more effectively on the financial markets. And the housing industry will have far less difficulties than it has today.

Senator MATTINGLY. You agree that DIDC ought to increase its phaseout?

Mr. RAMSEY. Say that again?

Senator MATTINGLY. Do you think they ought to phase out regulation Q at a faster rate?

Mr. RAMSEY. Yes.

Senator MATTINGLY. You seem to favor tax schemes targeted to stimulate savings. Why not simply exclude all forms of savings from the base used to define taxable incomes?

Mr. RAMSEY. That is an idea that is somewhat close to the one that I have mentioned. One can argue both ways on this as to whether or not for social policy purposes one wants to do that.

I was merely raising the scheme that I did to indicate or give a suggestion that if one wished to stimulate savings and therefore provide a greater fund from which investment can take place—private domestic investment.

There are ways to do it if we wish to consider them, and this was a suggestion. The impact would be on the savings rate. It would be quite enormous, if we were to allow people to deduct.

The other part of the idea that I had was to recognize that we need to encourage risk taking. We need to encourage people to engage in venture capital to help build new plants, new equipment, new firms rather than dissipate the money, for example, in buying gold, buying silver, buying rare finds and antiques.

On that basis my idea was to restrict the subsidy to new security issues—the new issue of bonded debt for new plant and equipment—and for the generation of new ventures.

If we were to do that, I think the increase in the venture capital would be absolutely enormous. It would have a considerable impact in our ability to compete in the future, and the question about the degree of increase of machine tool orders raised by Congressman Richmond, I think would receive a very healthy stimulus.

Senator MATTINGLY. Congressman Richmond.

Representative RICHMOND. Mr. Ramsey, I listened to your testimony with the greatest of interest, but have you ever run a business?

Mr. RAMSEY. Have I ever run a business? Currently, I look after a very large department.

Representative RICHMOND. Have you ever run an industrial business?

Mr. RAMSEY. I have been a consultant, I am involved with a firm that survives and——

Representative RICHMOND. Like Mr. Weidenbaum, you have never run a business?

Mr. RAMSEY. I am involved with a firm that survives or falls on the basis of profits.

Representative RICHMOND. You say risk. Now, the Federal Government backs up every single risk everyone takes in the whole United States because most risks are tax deductible; right?

Mr. RAMSEY. Not entirely.

Representative RICHMOND. You want the Federal Government to back up——

Mr. RAMSEY. No; you misread me, Congressman Richmond. Or rather, I misspoke to mislead you and I apologize.

I do not wish to bail out the housing industry—my comments that I do not have here but I have made elsewhere concerns the attempts to bail out Lockheed and so on. No; I would not bail out these firms.

To advocate a sort of supply-side or market-oriented approach is not to subscribe that you bail out firms for taking foolish action.

Representative RICHMOND. The statement you made that you think capital investment ought to be accorded even more special treatment based on taxes to encourage capital investment, worries me.

Mr. RAMSEY. I said, if you wish to encourage the flow of savings there are ways in which to do it.

Representative RICHMOND. If you wish to encourage the flow of savings there are ways to do it, but until you drop the interest rates there is no way you are going to encourage the flow of savings into risk taking—not when any saver can go out and buy himself or herself a Treasury bond or a certificate of deposit at roughly 14 percent.

Why would anybody go take a risk when you can go out and get something as good as gold at 14 percent. When, in the history of the United States have we been able to buy anything quite as solid as a Treasury bond or as a certificate of deposit and get that kind of return?

Your problem is not risk taking, your problem is to reduce interest rates. And the only way you are going to reduce interest rates is to reduce the amount of money the Government requires each year of general savings.

Next year the U.S. Government will require 75 percent of every single dollar that Americans save to keep the Government going. I wish someone would state that problem that clearly. The U.S. Government next year will take $150 billion out of the savings market—the savings market is only $200 billion.

Now how do you expect anybody to have enough money to recapitalize their factories at reasonable interest rates when you have got the U.S. Government auctioning off Treasuries at ever higher rates in order to chase every one of those dollars?

Mr. RAMSEY. May I respond?

Representative RICHMOND. Yes.

Mr. RAMSEY. I think there is more agreement here than apparently met your eye.

Your comments raise a whole series of questions—I'm not too sure how many of them and in which order to take them.

First, the point of my table 1 in my prepared statement is to indicate exactly what you said. We have now come to the point in time—starting at about the early 1970's—where the Federal deficit is reaching a proportion where it is competing on an equal basis—50 to 100 percent, possibly more than 100 percent—equal to the total size of net private domestic investment. Which we must do something about.

If indeed, given that, this has now become a serious issue. It was not an issue in the 1950's and 1960's, but it is now a serious issue and, therefore, needs addressing.

I pointed out that one of the differential effects in terms of handling a deficit, either taking it on to the open market or raising taxes or lowering expenditures, that between those three I pointed out that if you take the first approach—which is to go into the open market—that the entire burden of transfer payments then gets in a sense put onto the savings of others.

Whereas, if you raise taxes—although I am not advocating that—only about one-tenth goes on to the savings—tackles the savings because of the increase in the taxation rate. And most of it goes onto the reduced consumption that otherwise would have occurred by those who were taxed.

The third alternative to a large extent I would favor—because I feel there has been an unnecessary increase in the growth of government—would be to reduce expenditures.

That is my personal feeling as to whether one should reduce expenditures, raise taxes, monetize or go into the open market. In terms of ordering the extent to which I feel they are incorrect and that we should not follow them, I would put at the top that going onto the open market to fund the deficit; two, monetize it; three, raise taxes; and four, reduce expenditures.

I would rather reduce expenditures as opposed to anything else.

On the second issue with respect to interest rates, while interest rates in this country are very high, they are piddling compared to, say, Latin America. And business still continues.

Representative RICHMOND. Interest rates in the United States are the highest of any major Western industrial country, so don't compare us with Latin America.

We are talking about major industrial countries, and our interest rates are almost double anyone else's rates in the entire world today.

Mr. RAMSEY. Congressman Richmond, may I finish?

I agree with you, the interest rates are high. But they are high because in the main we still have very high expectations about future inflation.

If you listen to what is coming out of Congress and so on at this time, and you listen to people's reactions to it, it is very obvious as to why people do expect very high rates of inflation still to occur in the future, notwithstanding the fact that the current interest rate has tended to go down.

People are expecting very high inflation in the future, and therefore they are tending to demand high premiums to maintain a high nominal interest rate. The real interest rate is not very high at all.

Given whatever level of nominal interest rate, whether people invest at the interest rates, depends on the returns they expect to get if the interest rate were 25 percent and you expected to get 200 percent rate of return, then you would pay the 25 percent rate of interest, but given the height of interest rates as they are now, and given people's expectations as to the profitability of future investments, there is an issue. It is the size of the interest rate relative to the expected profitability of the firms involved, which causes the problem. The absolute level of interest rates, in a sense, is not high—it sounds large by historical standards, and is very high by historical standards—but it causes problems which I think go beyond what we are discussing at the moment. The key issue for firms, that if your expected profit rate exceeds 18 percent, then you will invest. The point is that the expected profit rates are not at those levels, in that the risk most firms take——

Representative RICHMOND. My time is up. But I must say that what I'm hearing is sort of nonsense. The average profit rate in the United States in a good year of average corporations is 10 percent before taxes. That is historical average. Many corporations are trying to get to that, the 10 percent of sales, 5 percent after taxes. Now with interest at 18 percent, there is no way any corporation can afford to borrow money to improve itself, and that's what worries me. How are we going to get out of the mess we're in? How are we going to compete with the Japanese and the Germans who have cheap money? Any Japanese corporation can borrow as much money as it wants at 5½ and 5¾ percent. How are we going to do that—while the Japanese keep modernizing their factories—and how are we ever going to get competitive unless we drop our interest rates or form a Reconstruction Finance Corporation, which I think is crucial?

My time is up. Thank you, Senator.

Senator MATTINGLY. We thank you for coming. I have run a business before I got in the U.S. Senate. If we ran the Government like we run our businesses, we would not have that problem. The whole problem still gets right back to the Federal budget. If you want to bring up little things in the Federal budget that are off budget like the FFB and many other things, it still gets down, right back down to a plan or no plan. The plan is to get control of the Federal budget and decrease the spending of the Federal budget, which will then reduce the interest rates.

Thank you very much, Mr. Ramsey.

Mr. Tullock is our final witness.

STATEMENT OF GORDON TULLOCK, CENTER FOR THE STUDY OF PUBLIC CHOICE, VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY, BLACKSBURG, VA.

Mr. TULLOCK. Senator, I should say, the last time I made a statement before a congressional subcommittee, the court reporter lost the entire text, except the remark by the chairman that I should be brief, and my remark that I would be brief, together with his thanking me for my testimony. It was the briefest testimony I ever had. [Laughter.]

Although President Reagan has now held office for almost a year and a half, and although this is referred to as the Reagan administration, we should not overemphasize the impact of any President on events. He faces a Congress, one House of which is controlled by the opposition party and which, in any event, is full of individualists who aren't very much under the control of anyone. Further, the civil service is fairly clearly uncooperative with respect to his general plans. This latter point is best seen by the way the civil service has allocated budget cuts. They have turned overwhelmingly to cutting programs and only to a very minor extent to firing personnel. That a relief administrator would prefer to cut off school lunches to firing good old Joe down the hall is humanly understandable, but it does mean that the Government program doesn't work as well as it otherwise would.

Further, there are a number of other semiautonomous bodies who have considerable control over the economy. The obvious one is the Federal Reserve Board. Currently, the Federal Reserve Board is being praised for stopping the inflation and criticized for causing high interest rates and unemployment. It is not at all obvious that it deserves either the praise or the criticism. It is, however, clear that the President, at best, can influence this autonomous body, the members of which were mainly appointed by other people and none of whom he can fire. Granted the immense power of the Federal Reserve in our economic life, its independence from the President may be desirable but it does, however, mean that the President, to a very large extent, can neither be blamed nor take credit for its policies.

It is no doubt true that the President is much more influential in setting policy during his administration than any other person, but we should not exaggerate his impact. He is not and doesn't want to be a dictator, and we should not assume that the policies now being pursued are the result of his sole decision.

Having said this, however, we can at least make some comments as to how well the Government, as a whole, has done since January 3, 1981, keeping in mind we are talking about a rather diffuse organization with President Reagan being simply one, albeit an extremely important influence on its activities. The first thing to be said here is that politics is always dominant. Any economist asked to suggest economies for the Federal Government will almost instantly turn to the proposal that the farm subsidy program be discontinued. We are spending tax money for the purpose of making our food more expensive. The reason we do this is that a group of generally well-off people—the organized farmers—have political influence, not because there is any other motive. Granted the fact that the people who eat bread have lower incomes by far than the people who grow wheat, we are engaging in a straightforward regressive income transfer.

Having said that this is the first thing that any economist would suggest as a way of making economies, I have no difficulty at all in understanding why, politically, no one who wants to be reelected is going to push that particular economy.

This is characteristic of the general structure of the programs. Reforms which are economically desirable are frequently politically impossible. We may not find the political power to even have a budget this year. Thus, there is a strong restriction on the behavior of the Government in the economic field which is simply that it must be suc-

cessful in the political field first. To quote a very old aphorism, "In order to be a great Senator, one must first of all be a Senator." I don't imagine that anyone in this building has ever forgotten that.

The third problem confronting American economic policy at the moment is that macroeconomics, the study of depressions and booms, has disintegrated. We still understand inflation more or less and can stop it or start it when we want to. I should say that, looking at the numbers, I incline to the view that the current stopping of inflation represents less brilliant maneuvering on the part of the Federal Reserve Board than simple luck.

We are benefiting from some policies taken some time ago.

But if we understand, in general, inflation, even though we do face long and varying lags, when it comes to problems of prosperity and depression, we no longer have any feasible tools. The old rule of inflating a little bit in order to get out of unemployment no longer works. Speaking for economists, particularly my friends among the economists, I should say that this particular effect is one long predicted. If the Government went in as it did for gradually accelerating inflation, the parameters would change and the old simple rules would cease to work.

Unfortunately, although this as well known—certainly in the Chicago school, it unfortunately was ignored by the people making actual policy, not only in the United States but most Western countries. As a result, we no longer live in a "Keynesian" world where we can deal with unemployment by expansion of "demand." Indeed, we don't actually know how to deal with unemployment now. It is unfortunate that overenthusiasm in inflation led to throwing away a tool which today would certainly be useful. But in any event, that is water over the dam. We cannot go back to the past. We now live in a time in which unemployment may be correlated positively instead of negatively with the rate of inflation, or may be only randomly associated with it but clearly does not have a pronounced negative correlation.

So far, I have been explaining why the present-day world is a rather unsatisfactory place from the standpoint of economic policy. Politics heavily influences economic policy and, in any event, in certain areas we don't know what we should do. There are, however, a number of places where we do, indeed, know what is good economic policy.

Unfortunately, in these areas where we know what is good economic policy, the immediate effects are apt to be rather small. Thus, for example, the tax cuts which so far, of course, have only gone through a very mild first stage, will, indeed, in the long run raise the rate of growth and the rate of productivity in our economy.

Unfortunately, the effects are slow in coming, as we would anticipate. First, a great many people are, quite wisely, uncertain that the tax cuts will remain in place. Considering the present political situation in Washington, caution on the part of investors is obviously sensible. Second, when we do begin making investments, the effects will not be large, only that they will not occur all at once but will be spread out over time. The tax cut is a sensible policy, particularly if we are able to get expenditures down too, but its effects have hardly been felt.

That is rather characteristic of a great many government policies. To take a very minor one, the Federal Trade Commission is attempting

to rearrange its prosecution schedule so that it will stop harassing competitive business and concentrate on places where there are genuine monopoly problems. First, it will be a number of years before businessmen realize that this change has occurred and, second, the beneficial effects will also take time. They will come but they will take time.

Similarly, the failure of the Government to expand regulation and, in fact, to some extent its activity in reducing it by limiting some of the more foolish regulations will in the long run have beneficial effects, but the effects will only be felt in the long run.

Looking at Reagan administration activity, I would say that because of political obstacles, it really has not done anywhere near as much as I would like to have had it do. I realize, however, that we are in a democracy and, indeed, have no desire to get out of a democracy. If, on the other hand, I considered what it has done and what it has tried to do, it seems to me that it is very clearly moving in the right direction. It inherited a very serious mess, and has taken a number of steps which will in the long run help to clear that mess.

We are, however, still to a large extent suffering from the long-run effects of previous policies and the long-run effect of the policies now being put in place have not yet been felt.

So much for my oral statement.

Thank you.

Senator MATTINGLY. Thank you, Mr. Tullock.

[The prepared statement of Mr. Tullock follows:]

Prepared Statement of Gordon Tullock

The United States Since January 3, 1981.

Although President Reagan has now held office for almost a year and a half, and although this is referred to as the Reagan Administration, we should not over emphasize the impact of any President on events. He faces a Congress, one house of which is controlled by the opposition party and which, in any event, is full of individualists who aren't very much under the control of anyone. Further, the Civil Service is fairly clearly uncooperative with respect to his general plans, this latter point is best seen by the way the Civil Service has allocated budget cuts. They have turned overwhelmingly to cutting programs and only to a very minor extent to firing personnel. That a relief administrator would prefer to cut off school lunches to firing good old Joe down the hall is humanly understandable, but it does mean that the government program doesn't work as well as it otherwise would.

Further, there are a number of other semi-autonomous bodies who have considerable control over the economy. The obvious one is the Federal Reserve Board. Currently, the Federal Reserve Board is being praised for stopping the inflation and critized for causing high interest rates and unemployment. It is not at all obvious that it deserves either the praise or the criticism. It is, however, clear that the President, at best, can influence this autonomous body, the members of which were mainly appointed by other people and none of whom he can fire. Granted the immense power of the Federal Reserve in our economic life, its independence from the President may be desirable but it does, however, mean that the President, to a very large extent, can neither be blamed nor take credit for its policies.

It is no doubt true that the President is much more influential in setting policy during his administration than any other person, but we should not exaggerate his impact. He is not and doesn't want to be a dictator, and we should not assume that the policies now being pursued are the result of his sole decision.

Having said this, however, we can at least make some comments as to how well the government, as a whole, has done since January 3, keeping in mind we are talking about a rather diffuse organization with President Reagan being simply one, albeit an extremely important influence on its activities. The first thing to be said here is that politics is always dominant. Any economist asked to suggest economies for the Federal government will almost instantly turn to the proposal that the farm subsidy program be discontinued. We are spending tax money for the purpose of making our food more expensive. The reason we do this is that a group of generally very well off people--the organized farmers--have political influence, not because there is any other motive. Granted the fact that the people who eat bread have lower incomes by far than the people who grow wheat, we are engaging in a straightforward regressive income transfer.

Having said that this is the first thing that any economist would suggest as a way of making economies, I have no difficulty at all in understanding why, politically, no one who wants to be reelected is going to push that particular economy. President Reagan, after all, was not nominated for the presidency in 1976, to a considerable extent because he openly said that he was opposed to the program. I am sure he remembers it and so do all the other active politicians who dominate Washington life.

This is characteristic of the general structure of the programs. Reforms which are economically desirable are frequently politically impossible. We may not find the political power to even have a budget this year. Thus, there is a strong restriction on the behavior of the government in the economic field which is simply that it must be successful in the political field first. To quote a very old aphorism, "In order to be a great Senator one must first of all be a Senator." I don't imagine that anyone in this building has ever forgotten that.

The third problem confronting American economic policy at the moment is that macro-economics, the study of depressions and booms, has disintegrated. We still understand inflation more or less and can stop it or start it when we want to. I should say that, looking at the numbers, I incline to the view that the current stopping of inflation represents less brilliant maneuvering on the part of the Federal Reserve Board than simple, dumb luck. Like most economists, of course, I tend to think of the Federal Reserve Board as an exceptionally incompetent organization. But in this case, it is not just its general reputation but an examination of the actual movement of M-1 and M-2 under its recent administrations that lead me to this conclusion. The money supply, in fact, is expanding at a rate which in the long run will certainly lead to a minor, although not very severe, inflation unless it is corrected. The stability of the price level comes from the lack of an immediate close connection between the money supply and the price level. As Friedman has many times said, "the lags are long and varying."

But, if we understand, in general, inflation even though we do face long and varying lags, when it comes to problems of prosperity and depression we no longer have any feasible tools. The old rule of inflating a little bit in order to get out of unemployment no longer works. Speaking for economists, particularly my friends among the economists, I should say that this particular effect is one long predicted. If the government went in as it did for gradually accelerating inflation, the parameters would change and the old simple rules would cease to work. Unfortunately, although this was well known--certainly in the Chicago School,[1] it unfortunately was ignored by the people making actual policy, not only in the United States but most western countries. As a result, we no longer live in a "Keynesian" world where we can deal with unemployment by expansion of "demand". Indeed, we don't actually know how to deal with unemployment now. It is unfortunate that overenthusiasm in inflation led to throwing away a tool which today would certainly be useful. But, in any event, that is water over the dam. We cannot go back to the past. We now live in a time in which unemployment may be correlated positively instead of negatively with the rate of inflation or may be only randomly associated with it but clearly does not have a pronounced negative correlation.

So far, I have been explaining why the present day world is a rather unsatisfactory place from the standpoint of economic policy. Politics heavily influences economic policy and, in any event, in certain areas we don't know what we should do. There are, however, a number of places where we do

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[1]For my own comments on it, see "Can You Fool All of the People All of the Time?" Journal of Money, Credit and Banking 4, May 1972, pp. 426-430.

indeed know what is good economic policy. Unfortunately, in these areas where we know what is good economic policy the immediate effects are apt to be rather small. Thus, for example, the tax cuts which so far, of course, have only gone through a very mild first stage, will indeed, in the long run raise the rate of growth and the rate of productivity in our economy. Unfortunately, the effects are slow in coming, as we would anticipate. Firstly, a great many people are, quite wisely, uncertain that the tax cuts will remain in place. Considering the present political situation in Washington, caution on the part of investors is obviously sensible. Secondly, when they do begin making investments the effects will again be slow. This does not mean that the effects will not be large, only that they will not occur all at once but will be spread out over time. The tax cut is a sensible policy, particularly if we are able to get expenditures down, too, but its effects have hardly been felt.

This is rather characteristic of a great many government policies. To take a very minor one, the Federal Trade Commission is attempting to rearrange its prosecution schedule so that it will stop harrassing competitive businesses and concentrate on places where there are genuine monopoly problems. Firstly, it will be a number of years before businessmen realize that this change has occurred and, secondly, the beneficial effects will also take time. They will come but they will take time.

Similarly, the failure of the government to expand regulation and, in fact, to some extent its activity in reducing it by limiting some of the more foolish regulations, will in the long run have beneficial effects, but the effects will only be felt in the long run.

Looking at Reagan administration activity, I would say that because of political obstacles it really has not done anywhere near as much as I would like to have had it done. I realize, however, that we are in a democracy and, indeed, have no desire to get out of a democracy, and these political difficulties are characteristic of democracy. If, on the other hand, I considered what it has done and what it has tried to do, it seems to me that it is very clearly moving in the right direction. It inherited a very serious mess, and has taken a number of steps which will in the long run help to clear that mess. We are, however, still to a large extent suffering from the long-run effects of previous policies, and the long-run effect of the policies now being put in place have not yet been felt.

Mr. TULLOCK. For Congressman Richmond's benefit, I should say I am a member of the board of directors of a small company in Iowa and a substantial stockholder. [Laughter.]

Representative RICHMOND. Congratulations.

Mr. TULLOCK. It is high profit, but I don't think it's from my managerial skills; it is my colleagues that provide the brain power—and they should be congratulated.

Senator MATTINGLY. I have a few questions, Mr. Tullock.

One question: What were you referring to in your prepared statement when you said, "it is unfortunate that over-enthusiasm on inflation led to throwing away a tool that today would be useful"? What tool?

Mr. TULLOCK. Two things, in essence. In the first place, I think governments frequently inflate because they would rather not raise taxes. I think that is one of the reasons for the inflation, the monetization of the debt, you borrow money and inflate.

But it has to be said that if you look at the quality of economic advice governments were getting in the period from roughly 1950 to 1973–74, thereabouts, a lot of economists were very enthusiastic about the use of inflation, and did not seem to notice that the rate of inflation that was necessary to be increased was going up steadily.

So you had, I think, what I would call a political motive, a desire to spend money without taxing, together with some unfortunately bad advice. I did not give it, but it has to be said that a good many economists did offer bad advice at that time.

Senator MATTINGLY. Of course, inflation is a tax.

Mr. TULLOCK. Yes. A particularly unfortunate tax. The only nice feature about it, I should say, is that a lot of the Government debt is held by European central banks, so we have got back a good deal of our aid program by shrinking their holdings.

Senator MATTINGLY. Fortunately, now we have indexing and it will probably help wipe out—I don't know what it will do to the other countries—at least some of the pork barrels that we had here, that were using inflation and bracket-creep to pad whatever they were padding.

Mr. TULLOCK. We had an aid program for the deutsche mark.

Senator MATTINGLY. I have no more questions.

Representative RICHMOND. Mr. Tullock, a couple of things that you said I just cannot let go by. The 8 years that I have been in Congress, I have devoted myself to agricultural matters.

You know, for example, that last year our exports of agricultural goods were $60 billion?

Mr. TULLOCK. Deficit?

Representative RICHMOND. American farmers exported $60 billion worth of agricultural products. That was our major export.

Mr. TULLOCK. It usually is.

Representative RICHMOND. The Government subsidizes farmers to the tune of $6 billion, so the total subsidy——

Mr. TULLOCK. It is a range——

Representative RICHMOND. The total subsidy of all agricultural products came to $6 billion. We exported $60 billion. That is one small fact.

Now, do you realize that agricultural commodities right now, if they were indexed back to the Great Depression, would be selling at considerably lower prices than they were during the depression?

Mr. TULLOCK. I hope so. We are much more efficient. One hopes prices come down when you improve efficiency.

Representative RICHMOND. You hope we are now selling our corn, wheat, and soybeans at effectively lower prices than we were during the depression; and on the other side, you deplore the fact that our Government is subsidizing corn, wheat, and soybeans, and dairy products—to the tiny amount of $6 billion in a budget of our size, which is less than 1 percent of our total budget.

And you are complaining that the farmers in the United States are making too much money?

Mr. TULLOCK. Remember, I told you, I am on the board of directors of a little company located in Iowa. As a result of that, I visit Iowa fairly frequently, and in fact when I leave Waterloo Airport to go to Iowa, I drive through Grundy County, the wealthiest county in the United States, which makes it quite difficult to do with respect to the oil companies. But the oil companies have more people.

And you see these farms, sitting out, worth a million dollars or so. I simply cannot get—feel sorry for those people. I must say I don't. They are good technicians.

Representative RICHMOND. You are taking one example, which does not account for the entire farm community. The farm community cannot buy equipment. The farm community cannot borrow money. Bankruptcies and repossessions are taking place every single day of the week.

Mr. TULLOCK. To some extent.

Representative RICHMOND. There is the finest company in the world that has closed down. John Deere. Their earnings were off 97 percent last quarter. International Harvester is on its way to bankruptcy.

Mr. TULLOCK. I hope it goes bankrupt. I am in favor of large companies going bankrupt now and then. It encourages management of the other companies.

Representative RICHMOND. That is glib.

Mr. TULLOCK. It is nevertheless true. When a company goes bankrupt, it doesn't necessarily stop functioning. Braniff did, but that is unusual.

One of the problems in answering your questions is, you ask a long list and I cannot remember the earlier ones by the time you get to the end.

Representative RICHMOND. You are saying that we ought to reduce farm subsidies——

Mr. TULLOCK. I would like to get rid of them.

Representative RICHMOND. It is incorrect. You do not understand the farmers problems. You do not realize the farmer is getting less money for his crops than he has even since the last depression. Meanwhile, the cost of operating has gone up.

Mr. TULLOCK. Look at their incomes, and you tell me the costs have gone up and the prices have gone down. They are making large sums of money.

Representative RICHMOND. They are not. The average farmer last year made $10,000. Look at some published figures.

Mr. TULLOCK. The average farmer—you just gave the average person living on a farm?

Representative RICHMOND. Last year they had an income of $10,000. An average farm of 452 acres, the average farm in the United States.

Before you come here with statements about farming, you should look at some of your facts.

Mr. TULLOCK. I am fairly aware of them.

Could I ask you a question on that number? Is that the people who draw more than one-half their income from farming?

Representative RICHMOND. A family farmer in the United States has an average acreage of 452 acres. His income last year was $10,000. Where he is going to get the money to survive this year, God only knows. And for you to say that we should reduce the subsidies makes very little sense.

Mr. TULLOCK. Do you represent a farming constituency?

Representative RICHMOND. I am the only urban member on the House Agricultural Committee. I have been farming all of my life.

Mr. TULLOCK. But you represent an urban constituency?

Representative RICHMOND. And I understand the problems of the farmer. And if every American does not understand, we will be in deep trouble. The farmer is the one person in the United States that is keeping our economy going right now.

Mr. TULLOCK. Because of the exports.

Representative RICHMOND. Yes.

Mr. TULLOCK. Ricardo pointed out you should never worry about exports, some 200 years ago, and no one has understood it.

Representative RICHMOND. The world has changed considerably.

Senator MATTINGLY. The time is up now and we are going to adjourn.

I think at the same time when we talk about farming, it would not be a bad idea to look at the dairy farming business—the subsidies versus the surplus that we have—at the same time we are putting more dairy farmers into business.

Mr. TULLOCK. Yes.

Senator MATTINGLY. Without any rationale. Whether you are a farmer or an industrialist, it does not make any sense. That could go on to the sugar industry and many other industries.

So, with that, I thank you very much.

The subcommittee is adjourned.

[Whereupon, at 11:07 a.m., the subcommittee adjourned, subject to the call of the Chair.]

[The following information was subsequently supplied for the record at the request of Representative Reuss:]

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June 9, 1982

The Honorable Murray L. Weidenbaum
Chairman
Council of Economic Advisers
Executive Office Building
Washington, D.C. 20506

Dear Mr. Chairman:

I was astonished by your statement in your testimony this morning that "In fact, the unpublished worksheets supporting our economic White Paper of February 18, 1981, estimated two consecutive quarters of negative growth, which corresponds to the common rule of thumb for calling a downturn a recession." I wish to strongly reaffirm my request that you immediately deliver to the Committee copies of the unpublished working papers to which you refer.

I would also like a response to the crucial question:

> Why, if the Administration knew in February of 1981 that there was a recession on the horizon, was this fact not conveyed to the American public in the February 18, 1981 Economic Recovery Program?

I would appreciate your prompt attention to this request and look forward to receiving the working papers.

Sincerely,

Henry S. Reuss

Henry S. Reuss
Chairman

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20506

June 16, 1982

RECEIVED JUN 18 1982

Dear Mr. Chairman:

I acknowledge the receipt of your June 9 letter which requested copies of the unpublished working papers that were used to support our economic White Paper of February 18, 1981.

My staff is reviewing that request, and we will be back in contact with you shortly.

Sincerely,

Murray L. Weidenbaum

The Honorable Henry S. Reuss
Chairman
Joint Economic Committee
G-133 Dirksen Senate Office Building
Washington, D.C. 20510

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

June 18, 1982

RECEIVED JUN 21 1982

Dear Mr. Chairman:

I am writing in response to your letter of June 9 which seeks information regarding the Administration's forecasts of the path of the economy during 1981. Your letter also restates your request for our unpublished working papers.

At a news conference following the announcement by the President of my appointment on January 23, 1981, I stated that "it would take a period of years to undo the economic damage that has been suffered by the American community." Clearly, I did not paint a rosy picture for 1981; on the contrary, I felt that year would continue to reflect the effects of earlier unfortunate policies.

This generally pessimistic short-term view was also contained in the President's White Paper of February 18, 1981, America's New Beginning: A Program for Economic Recovery, in which the forecast is made that real GNP growth for calendar year 1981 will be only 1.1% (p. 25). In developing support for that figure along with other forecasts, numerous alternative scenarios were reviewed to assure ourselves that the forecasts were mutually consistent. Given the low estimated number for annual growth during that year, some of the hypothetical scenarios contained one or more quarters of negative growth. These quarterly estimates were used only to verify the internal consistency of the annual estimate, and were not generated for the purpose of public disclosure.

Subsequent to the publication of the White Paper, I discussed our economic assumptions with your Committee at two meetings in February and March 1981. At the February 25 appearance the 1.1% figure was contained in my prepared statement. In my later appearance on March 24, the assumptions underlying this annual forecast were discussed in more detail. I emphasized at that time that:

> As in past Administrations, our forecasts are not the product of any single model or any single forecaster. The Administration has access to a number of commercial models, as well as several developed within the government over many years. All of these models have been used, at one stage or another, in the development of the forecasts. (p. 5)

At that time, I made it clear that the published assumptions were based on the collective judgment of various Administration officials who reviewed numerous alternative projections. I went on to say:

> Our forecast allows for the possibility of very sluggish economic activity -- or even a period of outright decline -- during the spring and summer quarters of the year, until the elements of the economic program are put into place. (p. 6)

Thus, your Committee was informed in March 1981 that the White Paper's forecast of sluggish economic activity for 1981 was based upon a variety of models, some of which assumed one or two quarters of decline in the GNP. I was therefore surprised by the astonishment expressed in your June 9 letter which implied that the basis for our 1981 forecast somehow had been concealed from your Committee. That forecast was available for all to see in the White Paper, and its basis was detailed in my testimony cited above.

Your letter requests copies of "unpublished working papers" generated by my staff, which reflect various stages of the internal deliberative process by which the Administration arrived at its economic forecasts for 1981 and beyond. These working papers consist of tables showing quarterly estimates of numerous economic indicators under various hypothetical assumptions. Some of the tables reflect assumptions that we rejected prior to arriving at those found in the White Paper; others are consistent with the White Paper. All of them, however, constitute part of an internal decisionmaking process by which members of the Administration and their staffs test various economic models and use their collective judgment to arrive at the best possible forecast of future economic activity. The ability of Executive officers candidly to deliberate among themselves, and to advise the President, would be seriously jeopardized if predecisional working papers were disclosed to outsiders. For this reason, among others, no Administration has to our knowledge released internal, predecisional worksheets reflecting tentative projections of quarterly economic behavior.

You are also certainly aware that quarterly projections are notoriously unreliable, and their publication by the CEA could have harmful, short-term economic effects. Generally, annual forecasts -- which we believe are more reliable -- are the only ones disclosed outside the Executive Branch. We hope you will agree with us that no useful purpose would be served by disclosing the Council's internal and tentative quarterly economic projections.

I am always pleased to provide answers to any questions you may have concerning the Council generally, and the basis for our 1981 forecasts in particular. Please do not hesitate to call me if you wish to discuss this matter further.

Sincerely,

Murray L. Weidenbaum
Chairman

The Honorable Henry S. Reuss
Chairman
Joint Economic Committee
G-133 Dirksen Senate Office Building
Washington, D.C. 20510

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June 21, 1982

The Honorable Murray L. Weidenbaum
Chairman
Council of Economic Advisers
Washington, D.C. 20500

Dear Mr. Chairman:

I have received your letter of June 18, 1982 explaining why you refuse to release the Administration's covered-up internal forecast of early 1981, which showed that the consequences of the Administration's economic policy would be a recession. Your letter makes a number of remarkable statements:

> "The quarterly estimates were used only to verify the internal consistency of the annual estimate, and were not generated for the purpose of public disclosure."
>
> "These working papers consist of tables showing quarterly estimates of numerous economic indicators under various hypothetical assumptions. Some of the tables reflect assumptions that we rejected prior to arriving at those found in the White Paper; others are consistent with the White Paper. All of them, however, constitute part of an internal decisionmaking process by which members of the Administration and their staffs test various economic models and use their collective judgment to arrive at the best possible forecast of future economic activity. The ability of Executive officers candidly to deliberate among themselves, and to advise the President, would be seriously jeopardized if predecisional working papers were disclosed to outsiders."
>
> "You are also certainly aware that quarterly projections are notoriously unreliable, and their publication by the CEA could have harmful, short-term economic effects."

I can only remind you that I was not the one who brought the existence of these "unpublished worksheets" to the attention of

Congress. You volunteered their existence.

On page 2 of your testimony of June 9, 1982 before our Committee, you said "...In fact, the unpublished worksheets supporting our economic White Paper of February 18, 1981, estimated two consecutive quarters of negative growth, which corresponds to the common rule of thumb for calling a downturn a recession." If to do so violates all of the qualifiers and incurs all of the damages mentioned in your June 18 letter, then why on June 9 when you appeared before the Committee did you volunteer this information?

In my judgment, your letter seeks to have the best of both worlds: First, you dangle internal documents before the Congress when it is useful to do so in support of some point you are seeking to make. Then you deny us access to these documents when the fact that they are deeply embarrassing to the Administration comes to light.

I repeat my request for immediate delivery to the Joint Economic Committee of the "unpublished worksheets" to which you refer in your testimony of June 9, 1982.

Sincerely,

Henry S. Reuss
Chairman

P.S. I note your statement that "Some of the tables reflect assumptions that we rejected prior to arriving at those found in the White Paper; others are consistent with the White Paper." My request is strictly limited to copies of those tables whose assumptions are consistent with the Administration's official forecast.

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